# AUDITING 1

*Audit Reports*

# NOTES

# AUDITED FINANCIAL STATEMENTS

The Basics

## I. THE INDEPENDENT AUDIT FUNCTION

### A. The Purpose of an Audit

The purpose of an audit is to provide financial statement users with an opinion on whether the financial statements are presented fairly, in all material respects, in accordance with the *applicable financial reporting framework.*

**PASS KEY**

The *applicable financial reporting framework* is the financial reporting framework that is acceptable in view of the nature of the entity and the objective of the financial statements, or that is required by law or regulation. Acceptable financial reporting frameworks include general purpose frameworks designed to meet the needs of a wide range of users (e.g., U.S. GAAP and International Financial Reporting Standards [IFRSs]), and special purpose frameworks (discussed in lecture A2).

**U.S. AUDITING STANDARDS VS. INTERNATIONAL STANDARDS ON AUDITING**

ISAs discuss both compliance frameworks and fair presentation frameworks when discussing applicable financial reporting frameworks. U.S. GAAS does not make any reference to compliance frameworks because all financial reporting frameworks used in the United States are fair presentation frameworks. A fair presentation framework is a financial reporting framework that requires compliance with the requirements of the framework and:

– acknowledges explicitly or implicitly that to achieve fair presentation of the financial statements, it may be necessary for management to provide disclosures beyond those specifically required by the framework; and

– acknowledges explicitly that it may be necessary for management, in extremely rare circumstances, to depart from a requirement of the framework to achieve fair presentation of the financial statements.

### B. Audit Function Adds "Credibility"

The auditor's report gives credibility to the financial statements. The auditors, as a group independent of management, have an objective view and can report on a company's activities without bias or conflict of interest. Without a report from an independent auditor, a company's financial statements would be meaningless, because the public would have little faith in financial statements issued by the inherently biased company.

### C. Responsibilities

The financial statements of an enterprise are prepared by the management of the enterprise, not by the independent auditor. Further, the financial statements are the product and property of the enterprise; the independent auditor merely audits and expresses an opinion on them.

#### 1. Management Responsibilities = Financial statements and internal control

An audit is conducted on the premise that management and, when appropriate, those charged with governance, are responsible for:

a. the *preparation and fair presentation* of the financial statements in accordance with the applicable financial reporting framework;

b. the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free of material misstatement due to error or fraud; and

c. providing the auditor with access to information and persons within the entity needed to complete the audit.

**PASS KEY**

The *preparation and fair presentation* of the financial statements requires:

1. identification of the applicable financial reporting framework;
2. preparation and fair presentation of the financial statements in accordance with the framework; and
3. inclusion of an adequate description of the framework in the financial statements.

### 2. Auditor Responsibilities = Attest function

The auditor is responsible for expressing an opinion on the financial statements based on the audit. The auditor is also responsible for having appropriate competence and capabilities to perform the audit, complying with relevant ethical requirements, maintaining professional skepticism, and exercising professional judgment throughout the planning and performance of the audit.

## D. Performance

In order to express an opinion, the auditor obtains *reasonable assurance* about whether the financial statements are free from material misstatement, whether due to error or fraud.

### 1. Reasonable Assurance

*Reasonable assurance* is a high, but not absolute, level of assurance. In order to obtain reasonable assurance, the auditor must:

a. plan the work and properly supervise any assistants;

b. determine and apply appropriate materiality levels;

c. identify and assess risks of material misstatement, whether due to fraud or error; and

d. obtain sufficient appropriate audit evidence.

### 2. Inherent Limitations of an Audit

The auditor is unable to obtain absolute assurance that the financial statements are free from material misstatement because of the following inherent limitations:

- Intangibles
- Impairment
- Asset life/salvage
- Bad debts
- Warranties
- Lawsuits

**a. The Nature of Financial Reporting**

Some financial statement items are subject to an inherent level of variability because they involve judgment by management or because they involve subjective decisions or assessments or a degree of uncertainty (e.g., accounting estimates).

**b. The Nature of Audit Procedures** = Fraud (intentional) or errors (unintentional)

There are practical and legal limits on an auditor's ability to obtain audit evidence, including:

(1) The possibility that management or others may not provide, intentionally or unintentionally, the complete information that is needed for the preparation and presentation of the financial statements or that is requested by the auditor.

(2) Fraud may be concealed in such a way that it is difficult to detect with audit procedures.

(3) An audit is neither an investigation into a wrongdoing nor does the auditor have specific legal powers.

c. **Timeliness of Financial Reporting and the Balance Between Cost and Benefit**

There is an expectation by users of financial statements that the auditor will form an opinion on the financial statements within a reasonable period of time and will achieve a balance between benefit and cost, recognizing that it is impracticable to address all information that may exist. Therefore, it is necessary for the auditor to:

(1) plan the audit so that it is performed effectively;

(2) direct efforts to areas most expected to contain risks of material misstatement; and

(3) use testing and other means of examining populations for misstatement.

# PROFESSIONAL STANDARDS

## I. AUDITING STANDARDS

### A. Generally Accepted Auditing Standards = GAAS

SAS

The auditor is responsible for the performance of a properly planned and executed audit in accordance with generally accepted auditing standards (GAAS). Note that compliance with GAAS is mandatory on all audit engagements.

Generally accepted auditing standards for the audits of nonissuers are issued by the AICPA's Auditing Standards Board (ASB) in the form of Statements on Auditing Standards (SAS). The ASB's Statements on Auditing Standards are outlined in Section AU of the AICPA Professional Standards.

**PASS KEY**

To address concerns about the clarity, length, and complexity of its standards, and to converge its standards with the International Standards on Auditing (ISAs), the ASB redrafted all of its SASs. These clarified SASs were issued by the ASB in late 2011 and are effective for audits of financial statements for periods ending on or after December 15, 2012. The clarified SASs are outlined in Section AU-C of the AICPA Professional Standards, to avoid confusion with the existing AU sections, which remain effective through 2013. The AU-C identifier will revert to AU in 2014. These Becker audit materials are based on the clarified SAS, which are testable on the CPA Exam starting on July 1, 2013.

### B. Generally Accepted Government Auditing Standards

GAGAS

Audits of government organizations, programs, activities, and of entities that receive government funds should be conducted in accordance with generally accepted government auditing standards (GAGAS), as covered later in the course.

### C. Public Company Accounting Oversight Board = PCAOB: required when auditing an "issuer" (public company)

PCAOB

The Public Company Accounting Oversight Board (PCAOB) was established pursuant to the Sarbanes-Oxley Act of 2002. The PCAOB establishes auditing and related professional practice standards to be used in the preparation and issuance of audit reports for issuers.

1. Issuers consist of entities subject to the rules of the SEC (primarily public companies).
2. The PCAOB is comprised of five full-time, financially literate members.
   a. Two members must be (or have been) CPAs, and the other three must not be (or must not have been) CPAs.
   b. A CPA can only act as the Chair of the Board if he or she has not practiced as a CPA for the past five years.
   c. No members of the Board can receive payments from a public accounting firm (other than fixed continuing payments, such as retirement payments).
3. Public accounting firms must register with the PCAOB in order to audit a public company. Registered firms are subject to Board inspection, disciplinary proceedings, and sanctions.

### 4. PCAOB Auditing Standards (AS)

AS

a. The PCAOB adopted, on an initial, interim basis, ASB standards, but continues to review each standard to evaluate whether it should be modified, repealed, replaced, or permanently adopted. The PCAOB has issued several of its own Auditing Standards (AS), which replace ASB Standards for audits of issuers. These Auditing Standards will be covered throughout the course.

> Be sure to visit the Becker website for possible updates to this area.

b. Note that the ASB retains the authority to set performance and reporting standards for audits of financial statements of nonissuers.

## D. International Standards on Auditing

ISA

The International Auditing and Assurance Standards Board (IAASB), a standard setting board of the International Federation of Accountants (IFAC), establishes International Standards on Auditing (ISA). The IFAC is a worldwide organization that establishes and promotes adherence to high-quality professional standards and works toward the international convergence of such standards. ISAs issued by the IAASB do not override the local laws and regulations or national standards that govern the audits of historical financial statements in particular countries. Over 100 countries are using or are in the process of adopting or incorporating the ISAs into their national auditing standards or are using the ISAs as a basis for preparing national auditing standards.

# II. STANDARDS FOR ENGAGEMENTS OTHER THAN AUDITS

An audit is merely one type of engagement an accountant may be called upon to perform. Each type of engagement has a different set of applicable professional standards, and the requirements, responsibilities, and limitations vary with the nature and scope of the engagement. Below is an overview of standards for engagements other than audits that will be tested on the Auditing and Attestation section of the CPA exam.

## A. Statements on Standards for Attestation Engagements

SSAE

Statements on Standards for Attestation Engagements (SSAE) are issued by the AICPA. These standards apply to attest engagements, covered later in the course. The SSAEs are outlined in Section AT of the AICPA Professional Standards.

## B. Statements on Standards for Accounting and Review Services

SSARS

The Accounting and Review Services Committee was established by the AICPA to establish standards for privately-held (nonissuer) companies not seeking audited statements. Statements on Standards for Accounting and Review Services (SSARS) are issued by this Committee, and they are applicable to unaudited financial statements or unaudited financial information of a nonpublic entity. SSARS are covered later in the course. The SSARS are outlined in Section AR of the AICPA Professional Standards.

## III. OTHER GUIDELINES

### A. AICPA Code of Professional Conduct

The AICPA Code of Professional Conduct provides members with guidelines for behavior in the conduct of their professional affairs. In addition, it provides assurance to the public that the profession intends to maintain high standards and to enforce compliance with these standards by its members. The Code of Professional Conduct applies to all services performed in the practice of public accounting. The Code of Professional Conduct is outlined in Section ET of the AICPA Professional Standards.

### B. Statements on Quality Control Standards

The AICPA Code of Professional Conduct requires firms providing auditing, attestation, and accounting and review services to adopt a system of quality control. A quality control system consists of policies and procedures designed, implemented, and maintained to ensure that the firm complies with professional standards and appropriate legal and regulatory requirements, and that any reports issued are appropriate in the circumstances. Statements on Quality Control Standards (SQCS) are issued by the Auditing Standards Board to provide guidance with respect to quality control. The SQCS are outlined in Section QC of the AICPA Professional Standards.

### C. Securities and Exchange Commission (SEC)

1. The Securities Acts of 1933 and 1934 have given this U.S. governmental commission the authority to set guidelines for U.S. publicly traded companies.
   a. The SEC publishes their regulations in the Accounting Series Releases and in Regulation S-K.
   b. Final standards adopted by the PCAOB do not become effective until they are approved by the SEC.

### D. Sarbanes-Oxley Act of 2002 = SOX

Sarbanes-Oxley Act

In the wake of the collapse of Enron and WorldCom corporations and the restatement of financial statements of a number of other SEC reporting companies, Congress passed the Sarbanes-Oxley Act of 2002 (hereafter "SOX").

### E. IFAC Code of Ethics for Professional Accountants

The International Ethics Standards Board for Accountants (IESBA), a standard setting board of the International Federation of Accountants (IFAC), establishes the IFAC Code of Ethics for Accountants. The IFAC Code is the foundation for the codes of ethics developed and enforced by member bodies of the IFAC. No IFAC member body or firm issuing reports in accordance with International Auditing and Assurance Standards is allowed to apply less stringent ethics standards than those outlined in the IFAC Code of Ethics for Accountants.

## IV. AUDITING GUIDANCE: THE GAAS HIERARCHY

There are three levels of auditing guidance.

### A. AICPA Statements on Auditing Standards (SASs) and PCAOB Auditing Standards

1. In the United States, auditors are required to comply with SASs published by the Auditing Standards Board for audits of nonissuers and PCAOB Auditing Standards for audits of issuers. The auditor should:
   a. Use professional judgment in applying the SASs or PCAOB Auditing Standards to a particular engagement.
   b. Be prepared to justify any departures from presumptively mandatory requirements (see below).
2. SASs and PCAOB Auditing Standards generally apply only in situations where auditing services are being rendered. However, a few auditing standards apply to other services, such as reviews of interim financial information and letters for underwriters.
3. Specific language is used within the SASs and PCAOB Auditing Standards to clarify the auditor's level of responsibility.
   a. The terms "**must**" or "**is required**" indicate an unconditional requirement, which must be followed in all cases where the requirement is relevant.
   b. The term "**should**" indicates a presumptively mandatory requirement, which must be followed in all cases where the requirement is relevant, except in rare circumstances in which departure from the requirement is permitted if there is appropriate justification, performance of sufficient alternative procedures, and thorough documentation.
   c. The terms "**may**," "**might**," and "**could**" indicate explanatory material that does not impose a professional requirement for performance.

| U.S. AUDITING STANDARDS VS. INTERNATIONAL STANDARDS ON AUDITING |
| --- |
| The ISAs contain only one category of professional requirements that require the auditor to comply with the requirements when relevant, except in rare circumstances, similar to the presumptively mandatory requirement under U.S. auditing standards. |

### B. Interpretive Publications

1. Interpretive publications are recommendations regarding how SASs should be applied in specific situations. They are not considered to be auditing standards. The auditor should:
   a. Consider the guidance provided by these publications in performing an audit.
   b. Be able to explain any departures, and how compliance with standards was otherwise achieved.
2. Interpretive publications include auditing interpretations of GAAS, exhibits to GAAS, auditing guidance provide in AICPA Audit and Accounting Guides, and AICPA Auditing Statements of Position (SOP).

### C. Other Auditing Publications

1. Other auditing publications have no authoritative status but may be helpful to the auditor.
2. Other auditing publications include auditing articles in the Journal of Accountancy (or other professional journal), auditing articles in the AICPA CPA Letter, continuing professional education materials, textbooks, and other auditing publications.

## V. OVERALL OBJECTIVES OF THE AUDITOR AND THE CONDUCT OF THE AUDIT

### A. Overall Objectives of the Auditor

The overall objectives of the auditor when conducting a financial statement audit are:

1. to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to error or fraud, which enables the auditor to express an opinion on whether the financial statements are presented fairly, in all material respects, in accordance with an *applicable financial reporting framework*; and
2. to report on the financial statements and communicate as required by GAAS based on the auditor's findings.

> **PASS KEY**
>
> When reasonable assurance cannot be obtained and a qualified opinion in the auditor's report is insufficient in the circumstances, GAAS require that the auditor disclaim an opinion or withdraw from the engagement, when withdrawal is possible under applicable law or regulation.

### B. Conduct of the Audit

An audit conducted in accordance with GAAS and applicable ethical requirements enables the auditor to fulfill the overall objectives of the auditor. General requirements related to the conduct of the audit are:

#### 1. Professional Skepticism

The auditor should plan and perform the audit with professional skepticism. Professional skepticism is the recognition that circumstances may exist that cause the financial statements to be materially misstated. Professional skepticism is necessary to the critical assessment of audit evidence. Auditors should be alert for:

a. Audit evidence that contradicts other audit evidence obtained.

b. Information that calls into question the reliability of documents and responses to inquiries that may be used as audit evidence. - Pressure

c. Conditions that indicate possible fraud. - Opportunity
- Rationalization

d. Circumstances that suggest the need for audit procedures in addition to those required by GAAS.

> **PASS KEY**
>
> The auditor should neither assume that management is dishonest nor assume unquestioned honesty. A belief that management is honest and has integrity does not relieve the auditor of the need to maintain professional skepticism or allow the auditor to be satisfied with less than persuasive evidence.

#### 2. Ethical Requirements

The auditor should comply with ethical requirements related to financial statement audit engagements, including **independence in both fact and appearance**. Ethical requirements include the AICPA Code of Professional Conduct and the rules of the state boards of accountancy and applicable regulatory agencies that are more restrictive.

> **PASS KEY**
>
> The auditor must be independent of an entity when performing an engagement in accordance with GAAS unless: a) GAAS provides otherwise, or b) the auditor is required by law or regulation to accept the engagement and report on the financial statements.

3. **Professional Judgment**

The auditor should exercise professional judgment in planning and performing an audit. Professional judgment is necessary because an audit requires interpretation of ethical requirements and GAAS, as well as informed decisions based on the application of knowledge and experience.

In an audit, professional judgment is necessary when making decisions about:

a. Materiality

b. Audit risk

c. The nature, extent and timing of audit procedures "NET"

d. Evaluating whether sufficient, appropriate, evidence has been obtained

e. Evaluating management's judgments in applying the applicable financial reporting framework

f. Drawing conclusions based on the audit evidence obtained

4. **Sufficient Appropriate Audit Evidence and Audit Risk**

To obtain reasonable assurance, the auditor should obtain sufficient appropriate audit evidence to reduce audit risk to an acceptably low level and thereby enable the auditor to draw reasonable conclusions on which to base the auditor's opinion.

5. **Compliance With GAAS**

The auditor should not represent compliance with GAAS in the auditor's report unless the auditor has complied with all GAAS relevant to the audit. If the objective of a relevant GAAS section cannot be achieved, the auditor should consider whether this prevents the auditor from achieving the overall objectives of the auditor and thereby requires the auditor, in accordance with GAAS, to modify the auditor's opinion or withdraw from the engagement.

In certain audit engagements, the auditor may be required to comply with other auditing requirements in addition to GAAS. GAAS do not override laws or regulations that govern an audit of financial statements. The auditor may conduct the audit in accordance with both GAAS and:

a. auditing standards issued by the PCAOB;

b. International Standards on Auditing;

c. government auditing standards (GAGAS); or

d. auditing standards of a specific jurisdiction or country.

Exam trick

Weak internal control ≠ Adverse opinion

## REPORTS ON AUDITED FINANCIAL STATEMENTS

### I. FORMING AN OPINION ON THE FINANCIAL STATEMENTS

The auditor should form an opinion on whether the financial statements are presented fairly, in all material respects, in accordance with the applicable financial reporting framework.

#### A. Financial Statements

Financial statements generally mean a complete set of general purpose financial statements, including the related notes. The applicable financial reporting framework determines the form and content of a compete set of financial statements. For example, under U.S. GAAP a complete set of financial statements includes a balance sheet, a statement of income (or comprehensive income), a statement of changes in equity, a cash flow statement, and related notes.

#### B. Fair Presentation in Accordance With the Applicable Financial Reporting Framework

In order to form the opinion, the auditor should evaluate whether, based on the applicable financial reporting framework:

1. the financial statements adequately disclose the significant accounting policies selected and applied, including a description of the applicable financial reporting framework;
2. the accounting policies selected and applied are consistent with the applicable financial reporting framework and are appropriate;
3. the accounting estimates made by management are reasonable;
4. the information presented in the financial statements is relevant, reliable, comparable, and understandable;
5. the financial statements provide adequate disclosures to enable the intended users to understand the effect of material transactions and events on the information conveyed in the financial statements;
6. the terminology used in the financial statements, including the title of each financial statement, is appropriate;
7. the overall structure and content of the financial statements is fairly presented; and
8. the financial statements, including the related notes, represent the underlying transactions and events in a manner that achieves fair presentation.

### II. UNMODIFIED AUDIT OPINION = Clean opinion

The auditor should express an unmodified opinion when the auditor concludes that the financial statements are presented fairly, in all material respects, in accordance with the applicable financial reporting framework. The auditor's report should be in writing.

#### A. Title

"Independent" (auditor's report) should be included in the report title.

#### B. Addressee

The report is addressed as required by the circumstances of the engagement.

GR: Not to management

**C. Introductory Paragraph**

The introductory paragraph should:

1. identify the entity whose financial statements have been audited;
2. state that the financial statements have been audited;
3. identify the title of each financial statement; and
4. specify the date(s) or period(s) covered by each financial statement.

**D. Management's Responsibility for the Financial Statements**

M R

The auditor's report should include a section with the heading "*Management's* *Responsibility* for the Financial Statements" that includes:

1. an explanation that management is responsible for the preparation and fair presentation of the financial statements in accordance with the applicable financial reporting framework; and
2. a statement that this responsibility includes the *design*, *implementation*, and *maintenance* of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

D I M

**E. Auditor's Responsibility**

R

The auditor's report should include a section with the heading "Auditor's *Responsibility*" that includes:

E

1. A statement that the responsibility of the auditor is to *express* an opinion on the financial statements based on the audit.
2. A statement that the audit was conducted in accordance with auditing standards generally accepted in the United States of America.
3. P — A statement that those standards require that the auditor *plan* and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.
4. P — A description of the audit that states that:
   - a. O — An audit involves *performing* procedures to *obtain* audit evidence about the amounts and disclosures in the financial statements.
   - b. R — The procedures selected depend on the auditor's judgment, including the assessment of the *risks* of material misstatement of the financial statements, whether due to fraud or error.
   "Test"
   - c. T S — In making those risk assessments, the auditor considers *internal control* relevant to the entity's preparation and fair presentation of the financial *statements* in order to design audit procedures that are appropriate in the circumstances, *but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control, and accordingly, no such opinion is expressed.*
     - (1) The italicized portion of this statement should be omitted if the auditor does have a responsibility to express an opinion on the effectiveness of internal control in conjunction with the audit of financial statements.
   - d. C R A M E — An audit includes evaluating the appropriateness of the accounting policies used and the *reasonableness* of significant *accounting* estimates made by *management*, as well as *evaluating* the overall presentation of the financial statements.

5. A statement whether the auditor believes that the audit evidence obtained is sufficient and appropriate to provide a basis for the auditor's opinion.

**F. Auditor's Opinion**

The auditor's report should include a section with the title "Opinion" that includes:

Explicit statements

1. a statement that the financial statements present fairly, in all material respects, the financial position of the entity as of the balance sheet date and the results of operations and its cash flows for the period then ended, in accordance with the applicable financial reporting framework.
2. identification of the applicable financial reporting framework and its origin.

**G. Other Reporting Responsibilities**

If the auditor addresses other reporting responsibilities in the auditor's report in addition to GAAS, these other reporting responsibilities should be addressed in a separate section of the auditor's report subtitled "Report on Other Legal and Regulatory Responsibilities," or otherwise as appropriate.

If the audit report contains a separate section on other reporting responsibilities, the other sections of the audit report already described should be under the subtitle "Report on the Financial Statements."

**H. Signature of the Auditor**

The auditor's report should include the manual or printed signature of the auditor's firm.

**I. Auditor's Address**

The auditor's report should name the city and state (or country) where the auditor practices.

**J. Date of the Auditor's Report**

Dual dating

The auditor's report should be dated no earlier than the date on which the auditor has obtained sufficient appropriate audit evidence on which to base the auditor's opinion on the financial statements, including evidence that:

1. the audit documentation has been reviewed,
2. all the financial statements, including the related notes, have been prepared; and
3. management has asserted that they have taken responsibility for those financial statements.

**PASS KEY**

The auditor's report date shows the final date of auditor responsibility. For comparative financial statements, the audit report date for the most recent audit should be used.

*Note:* The auditor's reporting model outlined here is for audits of nonissuers. The appendix to this lecture gives an overview of the auditor's reporting model for issuers who are not required to have an integrated audit. Integrated audits for issuers are discussed in the A5 lecture.

## K. Sample Report—*Unmodified Opinion* *(reporting on a single year)*

**INDEPENDENT AUDITOR'S REPORT**

*[Appropriate Addressee]*

***Report on the Financial Statements***[1]

We have audited the accompanying financial statements of ABC Company, which comprise the balance sheet as of December 31, 20X1, and the related statements of income, changes in stockholders' equity, and cash flows for the year then ended, and the related notes to the financial statements.

***Management's Responsibility for the Financial Statements***

M R
D I M

**Management** is **responsible** for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the **design**, **implementation**, and **maintenance** of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement whether due to fraud or error.

R E P P O R T S

***Auditor's Responsibility***

Our **responsibility** is to **express** an opinion on these financial statements based on our audit. We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we **plan** and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

Test

An audit involves **performing** procedures to **obtain** audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the **risks** of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers **internal control** relevant to the entity's preparation and fair presentation of the financial **statements** in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal **control**. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the **reasonableness** of significant **accounting** estimates made by **management**, as well as **evaluating** the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

C R A M E

***Opinion***

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of ABC Company as of December 31, 20X1, and the results of its operations and its cash flows for the year then ended in accordance with accounting principles generally accepted in the United States of America.

***Report on Other Legal and Regulatory Requirements***

*[Form and content of this section of the auditor's report will vary depending on the nature of the auditor's other reporting responsibilities.]*

*[Auditor's signature]*

*[Auditor's city and state]*

*[Date of the auditor's report]*

[1] "Report on the Financial Statements" is unnecessary in circumstances when the second subtitle, "Report on Legal and Regulatory Requirements," is not used.

## L. Reference to Auditing Standards in the Auditor's Report

### 1. Audits of Issuers = Public company = PCAOB (SEC)

PCAOB Auditing Standard No. 1 requires the auditor's report to include a reference to the standards of the Public Company Accounting Oversight Board (United States).

> **"We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). "**

### 2. Audits of Nonissuers = Private company

a. The auditor's report should include a reference to generally accepted auditing standards in the United States of America:

> **"We conducted our audit in accordance with auditing standards generally accepted in the United States of America."**

b. If the audit was conducted in accordance with two sets of auditing standards in their entirety, the auditor may indicate that the audit was conducted in accordance with another set of auditing standards (e.g., International Standards on Auditing (ISAs), PCAOB standards, or government auditing standards). Additional language should be added to the Auditor's Responsibility paragraph to describe this situation:

> **"Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America and in accordance with International Standards on Auditing."**

**PASS KEY**

When the examiners require CPA candidates to respond to questions concerning the unmodified audit opinion, you must remember:

| | |
|---|---|
| GAAS → | Auditor's Responsibility Paragraph |
| GAAP (U.S. or other applicable financial reporting framework) → | Management's Responsibility Paragraph and Opinion Paragraph |

## M. Differences Between the Auditor's Report Under U.S. GAAS and the ISAs

### 1. Requirements in the ISAs and Not in U.S. GAAS

a. ISAs indicate that the description in the auditor's report can either refer to the preparation and fair presentation of the financial statements or the preparation of financial statements that give a true and fair view. U.S. GAAS does not include any references to "true and fair view."

b. ISAs require the introductory paragraph of the auditor's report to refer to the summary of significant accounting policies and other explanatory information. GAAS does not include this requirement because the notes to the financial statements are an integral part of the financial statements and specific notes do not need to be identified in the introductory paragraph.

c. ISAs require a statement in the Auditor's Responsibilities paragraph that the auditing standards require that the auditor comply with ethical requirements. GAAS does not contain this requirement because the title indicating that it is the report of an independent auditor affirms that the auditor has met the ethical requirements.

2. **Requirements in GAAS Not in the ISAs**

GAAS contains the following requirements not included in the ISAs:

a. A requirement that the description of management's responsibilities for the financial statements in the auditor's report should not be referenced to a separate statement by management about such responsibilities if such a statement is included in a document containing the auditor's report.

b. A requirement that sufficient appropriate audit evidence includes evidence that the audit documentation has been reviewed.

3. **Differences Between Requirements**

a. ISAs require the description of management's responsibilities to include an explanation that management is responsible for such internal control as it determines is necessary to enable the preparation of financial statements that are free from misstatement, whether due to fraud or error. GAAS requires the auditor's report to state that this responsibility includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of the financial statements.

## III. AUDITS OF GROUP FINANCIAL STATEMENTS

When an auditor acts as the auditor of group financial statements, the auditor must determine whether to make reference to any component auditors in the auditor's report on the group financial statements.

### A. Definitions

1. **Component**

A component is an entity or business activity that prepares financial information that is included in the group financial statements.

2. **Component Auditor**

A component auditor is an auditor who performs work on the financial information of a component that will be used as audit evidence for the group audit. A component auditor may be part of the group engagement partner's firm, a network firm, or another firm.

3. **Group Engagement Partner**

The group engagement partner is the partner or other person in the firm who is responsible for the group audit engagement and for the auditor's report on the group financial statements.

4. **Group Engagement Team**

The group engagement team includes the group engagement partner, other partners, and staff who establish the overall audit strategy, communicate with component auditors, perform work on the consolidation process, and evaluate the conclusions drawn from the audit evidence as the basis for forming an opinion on the group financial statements.

5. **Group Financial Statements**

Group financial statements are financial statements that include the financial information of more than one component.

## B. Understanding the Component Auditor

The group engagement team must understand the following for each component auditor:

1. Whether the component auditor is independent and will comply with all relevant ethical requirements
2. The professional competence of the component auditor
3. The extent to which the group engagement team will be involved in the work of the component auditor
4. Whether the group engagement team will be able to get information needed for the consolidation process from the component auditor
5. Whether the component auditor operates in a regulatory environment that actively oversees auditors

**PASS KEY**

If the component auditor is not independent or the group engagement team has serious concerns about any of the matters listed above, the group engagement team should not use the work of the component auditor or make reference to the component auditor in the auditor's report.

## C. Determining Whether to Make Reference to the Component Auditor in the Auditor's Report

The auditor should use the understanding of each component auditor to determine whether to make reference to the component auditor in the auditor's report. The decision is made individually for each component auditor.

### 1. Making Reference to the Component Auditor

#### a. Requirements

Reference to the component auditor should not be made unless the following requirements are met:

(1) The component auditor has performed an audit in accordance with the relevant requirements of GAAS, or when required, the PCAOB.

(2) The component auditor's report is not restricted use.

#### b. Use of a Different Financial Reporting Framework

If the component's financial statements are prepared using a different financial reporting framework from the group financial statements, reference to the component auditor should not be made in the auditor's report on the group financial statements unless:

(1) the measurement, recognition, presentation, and disclosure criteria used by the component under the component's financial reporting framework are similar to the criteria under the financial reporting framework used by the group.

(2) the group engagement team has obtained sufficient appropriate audit evidence to evaluate the appropriateness of the adjustments needed to convert the component's financial statements to the financial reporting framework used by the group (without needing to assume responsibility for the work of the component auditor).

#### c. Making Reference in the Auditor's Report

The auditor's report on the group financial statements should clearly indicate:

(1) that the component was not audited by the auditor of the group statements but was audited by the component auditor;

(2) the magnitude of the portion of the financial statements audited by the component auditor;

(3) when the component's financial statements are prepared using a different financial reporting framework from the group financial statements:

(a) the financial reporting framework used by the component; and

(b) that the auditor of the group financial statement is taking responsibility for evaluating the appropriateness of the adjustments to convert the component's financial statements to the group financial reporting framework.

(4) when the component auditor's report on the component's financial statements does not state that the audit was performed in accordance with GAAS or PCAOB standards and the group engagement partner has determined that the component auditor performed additional procedures to meet the relevant requirements of GAAS:

(a) the set of auditing standards used by the component auditor; and

(b) that additional audit procedures were performed by the component auditor to meet the relevant requirements of GAAS

| U.S. AUDITING STANDARDS VS. INTERNATIONAL STANDARDS ON AUDITING |
|---|
| ISAs do not permit the auditor's report on group financial statements to make reference to a component auditor unless required by law or regulation. |

**d. Modified Opinion Issued by the Component Auditor**

If the opinion of the component auditor is modified or the report includes an emphasis-of-matter or other-matter paragraph, the group auditor should determine the effect on the auditor's report on the group financial statements. When appropriate, the group auditor should modify the opinion on the group financial statements, or include an emphasis-of-matter or other-matter paragraph in the auditor's report.

**e. Sample Report—*Referencing the Audit of a Component Auditor***

**INDEPENDENT AUDITOR'S REPORT**

*[Appropriate Addressee]*

We have audited the accompanying consolidated financial statements of ABC Company and its subsidiaries, which comprise the consolidated balance sheets as of December 31, 20X1 and 20X0, and the related consolidated statements of income, changes in stockholders' equity, and cash flows for the year then ended, and the related notes to the financial statements.

***Management's Responsibility for the Financial Statements***

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of consolidated financial statements that are free from material misstatement whether due to fraud or error.

***Auditor's Responsibility***

Our responsibility is to express an opinion on these consolidated financial statements based on our audits. ***We did not audit the financial statements of B Company, a wholly-owned subsidiary, which statements reflect total assets constituting 20 percent and 22 percent, respectively, of consolidated total assets at December 31, 20X1 and 20X0, and total revenues constituting 18 percent and 20 percent, respectively, of consolidated total revenues for the years then ended. Those statements were audited by other auditors, whose report has been furnished to us, and our opinion, insofar as it relates to the amounts included for B Company, is based solely on the report of the other auditors.*** We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

(continued)

(continued)

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

***Opinion***

In our opinion, based on our audit **and the report of the other auditors**, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of ABC Company and its subsidiaries as of December 31, 20X1 and 20X0, and the results of their operations and their cash flows for the year then ended in accordance with accounting principles generally accepted in the United States of America.

[*Auditor's signature*]

[*Auditor's city and state*]

[*Date of the auditor's report*]

**2. Assumption of Responsibility**

When the group engagement partner decides to assume responsibility for the work of a component auditor, no reference to the component auditor should be made in the auditor's report because to do so may cause a reader to misinterpret the degree of responsibility being assumed.

**a. Additional Requirements When Assuming Responsibility**

When the group auditor is assuming responsibility for the work of a component auditor, the group engagement team should determine the type of work to be performed on the financial information of the components.

**(1) Significant Components**

A significant component is a component that is of individual financial significance to the group or that is likely to include significant risks of material misstatement of the group financial statements.

**(a) Significant Due to Individual Financial Significance**

A component that is significant due to individual financial significance should be audited by the group engagement team or the component auditor.

(b) **Significant Due to Significant Risks of Material Misstatement**

If a component that is significant because it is likely to include significant risks of material misstatement to the group financial statements, the group engagement team or a component auditor should perform an audit of the financial information, and/or an audit of the account balances, transactions or disclosures related to the likely significant risk of material misstatement, and/or perform specified procedures related to the likely significant risks of material misstatement.

(2) **Components That Are Not Significant**

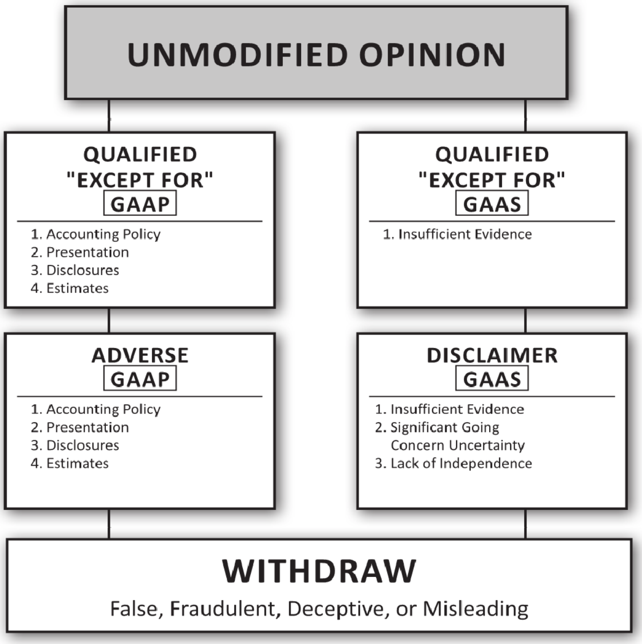
The group engagement team should perform analytical procedures for components that are not significant components.

## IV. TYPES OF OPINIONS

GAAP problem

Material

Very material (pervasive)




GAAS problem

Material

Very material (pervasive) (significant)

### A. Unmodified Opinion = GAAP and GAAS = OK

An unmodified opinion states that the financial statements present fairly, in all material respects, the financial position, results of operations, and cash flows of the entity in conformity with the applicable financial reporting framework.

1. **Emphasis-of-Matter and Other-Matter Paragraphs**

   In certain circumstances, the auditor may determine that it is necessary to add additional communications to the auditor's report without modifying the auditor's opinion. This is done using emphasis-of-matter and other-matter paragraphs.

## B. Modifications to the Auditor's Opinion

The auditor's report should be modified when:

1. the auditor concludes that the financial statements as a whole are materially misstated (GAAP issue); or
2. the auditor is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement (GAAS issue).

## C. Types of Modified Opinions

There are three types of modified opinions: the qualified opinion, the adverse opinion, and the disclaimer of opinion.

### 1. Qualified Opinion = GAAP or GAAS = Material issue

A qualified opinion states that except for the effects of the matter(s) to which the qualification relates, the financial statements present fairly, in all material respects, the financial position, results of operations, and cash flows of the entity in conformity with the applicable financial reporting framework.

### 2. Adverse Opinion = GAAP = Very material issue (pervasive)

An adverse opinion states that the financial statements do not present fairly the financial position, results of operations, or cash flows of the entity in conformity with the applicable financial reporting framework.

### 3. Disclaimer of Opinion = GAAS = Very material issue (pervasive) (significant)

A disclaimer of opinion states that the auditor does not express an opinion on the financial statements because the auditor was not able to obtain sufficient appropriate audit evidence to provide a basis for an opinion.

**PASS KEY**

When the auditor expresses an adverse opinion or a disclaimer of opinion on the financial statements as a whole, the auditor's report should ***not*** also include an unmodified opinion on a single financial statement or one or more specific elements, accounts, or items of a financial statement. Issuing such an unmodified opinion in these circumstances would contradict the adverse opinion or the disclaimer of opinion on the financial statements as a whole.

No piecemeal opinions

## D. Brief Summary of When to Use Different Opinions

| *Materiality of Problem* | *Financial Statements are Materially Misstated (GAAP Issues)* | *Inability to Obtain Sufficient Appropriate Audit Evidence (GAAS Issues)* |
|---|---|---|
| None or immaterial = | Unmodified | Unmodified |
| Material but not pervasive = | Qualified Opinion | Qualified Opinion |
| Material and pervasive = | Adverse Opinion | Disclaimer of Opinion |

**1. Definition of Pervasive** = Very material

Pervasive effects on the financial statements are those that in the auditor's professional judgment:

a. are not confined to specific elements, accounts, or items of the financial statements;

b. if so confined, represent a substantial proportion of the financial statements; or

c. are disclosures fundamental to the users' understanding of the financial statements.

| PASS KEY |
|---|
| A candidate must be able to identify the types of opinions available for GAAP issues (Qualified & Adverse) and for GAAS issues (Qualified & Disclaimer). |

## V. EMPHASIS-OF-MATTER AND OTHER-MATTER PARAGRAPHS

### A. Emphasis-of-Matter Paragraphs

An emphasis-of-matter paragraph is included in the auditor's report when required by GAAS or at the auditor's discretion. An emphasis-of-matter paragraph is used when referring to a matter that is *appropriately presented or disclosed in the financial statements* and is of such importance that it is fundamental to the users' understanding of the financial statements. The inclusion of an emphasis-of-matter paragraph in the auditor's report does not affect the auditor's opinion.

**1. Report Requirements**

When an emphasis-of-matter paragraph is included in the auditor's report, the auditor should:

a. place the emphasis-of-matter paragraph immediately *after* the opinion paragraph;

b. use the heading "Emphasis-of-Matter" or other appropriate heading;

Before "other matter"

c. describe the matter being emphasized and the location of relevant disclosures about the matter in the financial statements;

d. indicate that the auditor's opinion is not modified with respect to the matter emphasized.

**2. Use of Emphasis-of-Matter Paragraphs**

| Emphasis-of-Matter |
|---|
| Going Concern |
| Consistency |
| Changing Prior Opinion |
| Special Purpose Framework |

**a. Use Required**

An emphasis-of-matter paragraph is required in the following circumstances:

(1) The auditor concludes that there is substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time.

(2) To describe a justified change in accounting principle that has a material effect on the entity's financial statements.

(3) Subsequently discovered facts lead to a change in audit opinion (the auditor may use an emphasis-of-matter or other-matter paragraph, as appropriate).

(4) The financial statements are prepared in accordance with an applicable special purpose framework (other than regulatory basis financial statements intended for general use).

b. **Use May Be Necessary** = Professional judgment

An auditor can use an emphasis-of-matter paragraph when referring to any matter that is appropriately presented or disclosed in the financial statements and is of such importance that it is fundamental to the users' understanding of the financial statements. Examples include:

(1) An uncertainty related to the outcome of unusually important litigation or regulatory action

(2) A major catastrophe having a significant effect on the entity's financial position

(3) Significant related party transactions

(4) Unusually important subsequent events

After opinion and emphasis-of-matter

## B. Other-Matter Paragraphs

An other-matter paragraph is included in the auditor's report when required by GAAS or at the auditor's discretion. Other-matter paragraphs refer to matters other than those presented or disclosed in the financial statements that are relevant to the user's understanding of the audit, the auditor's responsibilities, or the auditor's report.

### 1. Report Requirements

When an other-matter paragraph is included in the auditor's report, the auditor should:

a. place the other-matter paragraph immediately *after* the opinion paragraph and *after* any emphasis-of-matter paragraph;

b. use the heading "Other-Matter" or other appropriate heading; and

c. describe the matter being emphasized and the location of relevant disclosures about the matter in the financial statements,

### 2. Use of Other-Matter Paragraphs

a. **Use Required**

An other-matter paragraph is required in the following circumstances:

(1) Anytime the auditor includes an alert in the audit report that restricts the use of the auditor's report.

(2) Subsequently discovered facts lead to a change in audit opinion (the auditor may use an emphasis-of-matter or other-matter paragraph, as appropriate).

(3) The financial statements of the prior period were audited by a predecessor auditor and the predecessor's audit report is not reissued.

(4) Current period financial statements are audited and presented in comparative form with compiled or reviewed financial statements for the prior period, or in comparative form with prior period financial statements that were not audited, reviewed or compiled.

(5) Prior to the audit report date, the auditor identifies a material inconsistency in other information that is included in a document containing audited financial statements that requires revision of the other information and management refuses to make the revision.

(6) When the auditor chooses to report on supplementary information presented with the financial statements in the auditor's report, rather than in a separate report.

(7) To refer to required supplementary information that a designated accounting standards setter requires to accompany an entity's basic financial statements.

(8) To restrict the use of the auditor's report when special purpose financial statements are prepared in accordance with a contractual or regulatory basis of accounting (except when regulatory basis financial statements are intended for general use).

(9) A report on compliance is included in the auditor's report on the financial statements.

**b. Use May Be Necessary**

An other-matter paragraph may be necessary in the following circumstances:

(1) To describe the reasons why the auditor cannot withdraw from an engagement when the auditor is unable to obtain sufficient appropriate audit evidence due to a management-imposed scope limitation and the possible effects on the financial statements of undetected misstatements could be both material and pervasive, but the auditor is unable to withdraw from the engagement.

(2) Law, regulation, or generally accepted practice require or permit the auditor to provide further explanation of the auditor's responsibilities.

(3) The auditor has been engaged to report on more than one set of financial statements when each set of financial statements has been prepared in accordance with a different general purpose framework.

## C. Auditor's Consideration of an Entity's Ability to Continue as a Going Concern

**Going Concern**

On every audit engagement, the auditor is responsible for evaluating audit evidence to determine whether there is substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time, not to exceed one year beyond the date of the financial statements being audited. If there is substantial doubt, the auditor should (i) consider the adequacy of disclosure about the entity's possible inability to continue as a going concern and (ii) include an *emphasis-of-matter paragraph* in the auditor's report to reflect this conclusion.

Valuation and classification

| Emphasis-of-Matter |
|---|
| Going Concern |
| Consistency |
| Changing Prior Opinion |
| Special Purpose Framework |

**U.S. AUDITING STANDARDS VS. INTERNATIONAL STANDARDS ON AUDITING**

ISAs require the auditor to consider the same period that was used by management in making its assessment of the entity's ability to continue as a going concern. This period must be *at least, but not limited to,* twelve months from the balance sheet date. The auditor is also required to inquire of management regarding conditions or events beyond the period of assessment that may cast significant doubt about the entity's ability to continue as a going concern.

### 1. Procedures

The auditor examines evidence obtained during the audit to determine whether there is information that is contrary to the basic principle of going concern. The auditor should examine the evidence obtained from the following procedures:

A a. ***A**nalytical procedures*

D b. ***D**ebt compliance*—The auditor should review the terms of debt and loan agreements

M c. ***M**inutes*—The auditor should review minutes from stockholder and board of director meetings

I d. ***I**nquiry* of client's legal counsel

T e. ***T**hird parties*—The auditor should confirm the details of financial support arrangements

S f. ***S**ubsequent* events review

| U.S. AUDITING STANDARDS VS. INTERNATIONAL STANDARDS ON AUDITING |
|---|
| ISAs state that the auditor should consider the going concern assumption throughout the engagement (when planning and performing audit procedures and in evaluating the results of audit procedures). U.S. auditing standards do not require specific procedures related to the going concern assumption, but instead require the auditor to consider whether the results of the audit procedures performed identify conditions and events that indicate that there could be substantial doubt about an entity's ability to continue as a going concern. |

### 2. Conditions and Events

Based on the procedures performed, the auditor identifies conditions and events that may be indicative of substantial doubt.

F a. ***F**inancial difficulties*—loan defaults, dividend arrearages, denial of usual trade credit, debt restructuring, noncompliance with capital requirements, new financing sources or methods, disposal of substantial assets

I b. ***I**nternal matters*—work stoppages, labor difficulties, substantial dependence on a particular project, uneconomic long-term commitments, significant revision of operations

N c. ***N**egative trends*—recurrent losses, working capital deficiencies, negative cash flows, adverse financial ratios

E d. ***E**xternal matters—legal proceedings, new legislation, loss of a key franchise, license, or patent, loss of a principal customer or supplier, natural disasters

Unmodified opinion ≠ Good investment

3. **Mitigating Factors**

When an auditor believes that there is substantial doubt about an entity's ability to continue as a going concern, the auditor is required to consider management's plans for dealing with the conditions or events that led to the auditor's belief, including:

a. Plans to borrow money or restructure debt

b. Plans to sell assets

c. Plans to delay or reduce expenditures

d. Plans to increase ownership equity

Note that mitigating factors must include both intent and the ability to carry out the planned procedures.

**U.S. AUDITING STANDARDS VS. INTERNATIONAL STANDARDS ON AUDITING**

ISAs state that management has a responsibility to assess the entity's ability to continue as a going concern and requires the auditor to evaluate management's assessment. U.S. auditing standards do not contain these requirements and only require the auditor to evaluate management's plans to deal with the adverse conditions or events that led to the conclusion that there is substantial doubt about the entity's ability to continue as a going concern.

4. **Alleviation of Doubt**

After considering management's plans, the auditor may decide that substantial doubt (about the entity's ability to continue as a going concern for a reasonable period of time) has been alleviated. In such cases, the auditor should still consider the need for disclosure of the conditions and events that initially gave rise to the substantial doubt.

5. **Emphasis-of-Matter vs. Disclaimer**

Although the general rule in going concern cases is to add an emphasis-of-matter paragraph to the unmodified opinion, the auditor is not precluded from choosing to disclaim an opinion due to a going concern uncertainty. The decision between an unmodified opinion with an emphasis-of-matter paragraph and a disclaimer of opinion is based on the auditor's judgment.

6. **Sample Emphasis-of-Matter Paragraph** *(U.S. GAAS)*

The wording of the emphasis-of-matter paragraph must include the terms "substantial doubt" and "going concern."

After

***Emphasis of Matter***

The accompanying financial statements have been prepared assuming that the Company will continue as a going concern. As discussed in Note X to the financial statements, the Company has suffered recurring losses from operations and has a net capital deficiency that raise *substantial doubt* about its ability to continue as a *going concern*. Management's plans in regard to these matters are also described in Note X. The financial statements do not include any adjustments that might result from the outcome of this uncertainty.

Don't say "for 1 year"

7. **Sample Emphasis-of-Matter Paragraph** *(International Standards on Auditing)*

The wording in the emphasis-of-matter paragraph under the ISAs is slightly different and includes the term "significant doubt," rather than "substantial doubt."

> ***Emphasis of Matter***
>
> Without qualifying our opinion, we draw attention to Note Z in the financial statements which indicates that the Company has suffered recurring losses from operations and has a net capital deficiency of XXX. These conditions, along with other matters as set forth in Note Z, indicate the existence of a material uncertainty which may cast significant doubt about the Company's ability to continue as a going concern.

8. **Documentation Requirements**

When the auditor believes there is substantial doubt about the ability of the entity to continue as a going concern for a reasonable period of time, the following items should be included in the audit documentation:

a. The conditions or events that gave rise to the substantial doubt;

b. Any mitigating factors that the auditor considers significant;

c. Audit work performed to evaluate management's plans;

d. The auditor's conclusion about whether substantial doubt remains or is alleviated; and

e. The effect of the auditor's conclusion on the evaluation of the financial statements and related disclosures, and on the resulting auditor's report.

> **U.S. AUDITING STANDARDS VS. INTERNATIONAL STANDARDS ON AUDITING**
>
> ISAs require the auditor to obtain written representations from management regarding its plans for future action. U.S. auditing standards do not contain this requirement, although a sample going concern representation is included in the authoritative literature related to Management Representations.

9. **Miscellaneous**

a. If, in the auditor's judgment, the entity's going concern disclosures are inadequate, a departure from GAAP exists. This may result in either a qualified or adverse opinion.

b. If the auditor's doubts about the entity's ability to continue as a going concern are removed in a subsequent period, the emphasis-of-matter paragraph of the prior period need not be repeated.

c. The auditor should communicate going concern issues to those charged with governance.

**PASS KEY**

A commonly tested area is the concept of going concern. The chart below summarizes the effects of going concern issues on the auditor's report.

| Going Concern | | |
|---|---|---|
| Adequate Disclosure | Inadequate Disclosure | Significant Going Concern Uncertainty |
| Unmodified with Emphasis-of-Matter Paragraph | GAAP Qualified or Adverse | GAAS Disclaimer |

| Emphasis-of-Matter |
|---|
| Going Concern |
| Consistency |
| Changing Prior Opinion |
| Special Purpose Framework |

**D. Lack of Consistency** *(acceptable/justified changes in accounting principle)*

Consistency deals with the comparability of the financial statements from year to year. Unless the auditor's report explicitly states otherwise, the auditor's report implies that the financial statements are comparable between periods. The auditor should evaluate whether the comparability of the financial statements between periods has been affected by a change in accounting principle or by an adjustment to correct a material misstatement in previously issued financial statements.

**1. Acceptability of a Change in Accounting Principle**

When evaluating the acceptability of an accounting change, the auditor should consider whether:

a. the newly adopted accounting principle is in accordance with the applicable financial reporting framework;

b. the method of accounting for the change is acceptable;

c. the disclosures related to the accounting change are appropriate and adequate; and

d. the entity has justified that the alternative accounting principle is preferable.

If the auditor is satisfied that all four criteria are met, the auditor should include an *emphasis-of-matter paragraph* in the auditors' report. If any of the criteria are not met, the auditor should evaluate whether the accounting change results in a material misstatement and modify the auditor's opinion accordingly.

**2. Effect of an Acceptable Change on the Auditor's Report**

The emphasis-of-matter paragraph should describe the change in accounting principle and provide a reference to the entity's disclosure about the change.

a. If the effect of a change is immaterial, no revision to the report is necessary.

b. The emphasis-of-matter paragraph should be included in the auditor's report in the period of the change in accounting principle and all subsequent periods, until the new accounting principle is applied to all periods presented

c. If the change in accounting principle is accounted for by retroactive restatement, the emphasis-of-matter paragraph is only needed in the period of the change.

d. A change in accounting estimate that is inseparable from a change in accounting principle should be described in an emphasis-of-matter paragraph (e.g. a change in depreciation method).

e. Other changes in accounting estimates or corrections of errors (i.e., mathematical mistakes, oversights, etc.) do not affect the consistency standard and do not affect the auditor's report.

Correction of error not acct. principle change (from cash → accrual)

f. Corrections of an error in accounting principle (e.g., from cash method to accrual method) affect consistency and require an emphasis-of-matter paragraph.

g. A change in reporting entity that results in financial statements that are, in effect, those of a different reporting entity should be described in an emphasis-of-matter paragraph.

h. If an entity's financial statements include a significant investment accounted for using the equity method, the auditor's evaluation of consistency should include consideration of the investee. If the investee makes a change in accounting principle that is material to the investing entity, the change should be described in an emphasis-of-matter paragraph.

i. If a material misstatement in previously issued financial statements is corrected, an emphasis-of-matter paragraph describing the restatement and referring to the company's disclosure of the matter should be included in the auditor's report in the period of the correction.

## E. Alert That Restricts the Use of the Auditor's Written Communication

**Other-Matter Paragraph**

The auditor may be required by GAAS or may decide that it is necessary to include language in the auditor's report (or other written communication) that restricts the use of the auditor's written communication. In the auditor's report, such language is included in an *other-matter paragraph*.

### 1. Use of the Alert That Restricts the Use of the Auditor's Written Communication

An auditor's written communication should include an alert that restricts its use when the subject matter of the auditor's written communication is based on:

a. measurement or disclosure criteria that are suitable for only a limited number of users who have an adequate understanding of the criteria;

b. measurement or disclosure criteria that are available only to specified parties; or

c. matters identified during an audit engagement that are not the primary objective of the audit engagement (commonly referred to as a by-product report).

### 2. Content of the Alert

Unless otherwise specified by GAAS, the alert that restricts the use of the auditor's written communication should include the following items:

a. A statement that the auditor's written communication is intended solely for the information and use of the specified parties.

b. Identification of the specified parties for whom use is intended.

(1) For a by-product report, the specified parties should only include management, those charged with governance, others within the entity, the parties to the contract or agreement, and/or the regulatory agency to whom the entity is subject.

(2) When the auditor is requested to add specified parties in addition to those identified in the alert, the auditor should obtain acknowledgement in writing from the parties of their understanding of the nature of the engagement, the measurement or disclosure criteria, and the auditor's written communication.

(3) If the other specified parties are added after the release of the auditor's written communication, the auditor should:

(a) amend the written communication to add the parties (but not change the date of the original written communication); or

(b) provide a written acknowledgment to management and the other parties that the parties have been added as significant parties and that no procedures were performed after the original date of the auditor's written communication.

c. A statement that the auditor's written communication is not intended to be and should not be used by anyone other than the specified parties.

### 3. Sample Other-Matter Paragraph

> ***Other-Matter***
>
> This report is intended solely for the information and use of [*list or refer to the specified parties*] and is not intended to be and should not be used by anyone other than these specified parties.

### 4. Alert Included in General Use Communications

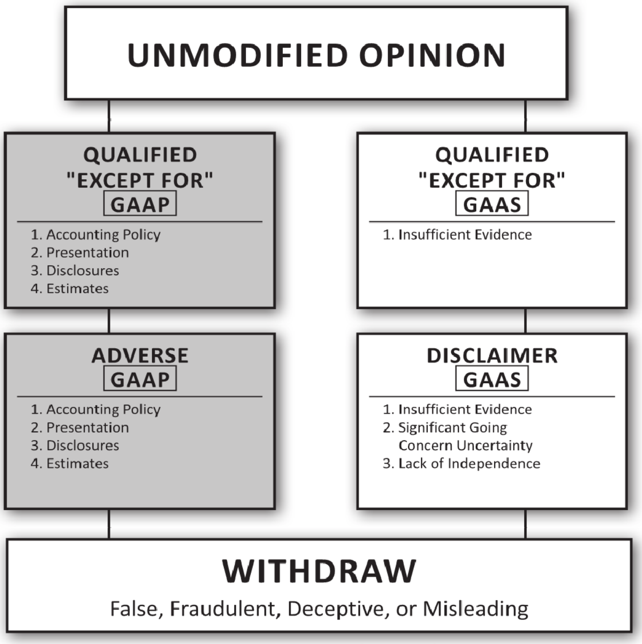
An auditor's written communication that is required by GAAS to include an alert that restricts its use may be included in a document that also includes an auditor's written communication that is for general use. In such circumstances, the use of the general use communication is not affected by the alert if the two types of communications are clearly differentiated, such as through the use of headers.

## VI. GAAP ISSUES: QUALIFIED OR ADVERSE OPINION

GAAP problem

Material

Very material (pervasive)




- GAAP consistency change (unjustified) = Auditor disagrees
- Inadequate disclosure
- Departure/violation of GAAP (unjustified)
- Unreasonable accounting estimate

## A. Qualified Opinion vs. Adverse Opinion

The auditor uses professional judgment to determine whether to issue a qualified opinion or an adverse opinion when audit evidence indicates that there is material misstatement of the financial statements.

| *Materiality of Problem* | *Financial Statements are Materially Misstated* (GAAP Issues) | *Inability to Obtain Sufficient Appropriate Audit Evidence* (GAAS Issues) |
|---|---|---|
| None or immaterial = | Unmodified | Unmodified |
| Material but not pervasive = | Qualified Opinion | Qualified Opinion |
| Material and pervasive = | Adverse Opinion | Disclaimer of Opinion |

### 1. Qualified Opinion

A qualified opinion should be expressed when the auditor concludes that misstatements, individually or in the aggregate, are material but not pervasive to the financial statements.

### 2. Adverse Opinion

An adverse opinion should be expressed when the auditor concludes that misstatements, individually or in the aggregate, are both material and pervasive to the financial statements.

## B. Nature of Material Misstatements

A material misstatement of the financial statements may arise in relation to the following:

1. The appropriateness of accounting policies
2. The application of accounting policies
3. The appropriateness of the financial statement presentation or the appropriateness or adequacy of disclosures in the financial statements

## C. Appropriateness of Accounting Policies

Material misstatements related to the appropriateness of accounting policies may arise when:

1. accounting policies are not in accordance with the applicable financial reporting framework;
2. the financial statements do not represent the underlying transactions and events in a manner that achieves fair presentation; or
3. the entity has not complied with the financial reporting framework requirements for accounting for and disclosing changes in accounting policies.

## D. Application of Accounting Policies

Material misstatements related to the application of accounting policies may arise when:

1. management has not applied accounting policies in accordance with the applicable financial reporting framework;
2. management has not applied accounting policies consistently between periods or to similar transactions and events; or
3. there is an error in the application of an accounting policy.

Make sure omission does not make FS
- False
- Fraudulent
- Deceptive
- Misleading

Withdraw

## E. Appropriateness of Financial Statement Presentation or Disclosures

Material misstatements related to the appropriateness of financial statement presentation or the appropriateness or adequacy of disclosures may arise when:

1. the financial statements do not include all required disclosures;
2. the disclosures are not presented in accordance with the applicable financial reporting framework;
3. the financial statements do not provide the disclosures needed to achieve fair presentation; or
4. information that is required to be presented, such as a statement of cash flows, has not been included or disclosed in the financial statements.

## F. Form and Content of Auditor's Report

When the auditor expresses a qualified or adverse opinion due to material misstatement of the financial statements, the "Auditor's Responsibility" paragraph is modified and the auditor's report will include a "Basis for Modification" paragraph and a "Qualified Opinion" or "Adverse Opinion" paragraph, as appropriate.

No change:
- Intro paragraph
- Mgt. responsibility paragraph

1. **Modification of Auditor's Responsibility Paragraph**

   When the auditor expresses a qualified or adverse opinion, the Auditor's Responsibility paragraph should be amended to state that the auditor believes that the audit evidence obtained is sufficient and appropriate to provide a basis for the auditor's modified audit opinion.

2. **Basis for Modification Paragraph**

   The Basis for Modification paragraph should be placed immediately *before* the opinion paragraph and should use the heading "Basis for Qualified Opinion" or "Basis for Adverse Opinion," as appropriate. The basis for modification paragraph should include:

   a. A description and quantification of the financial effects of any misstatement that relates to specific amounts in the financial statements.

      (1) If it is not practicable to quantify the financial effects, this should be stated.

      (2) If disclosure of the financial effects is made in the notes to the financial statements, the basis for modification paragraph can be shortened by referring to the disclosure.

   b. An explanation of how disclosures are misstated if there is a material misstatement related to narrative disclosure.

   c. A description of the nature of omitted information and inclusion of the omitted information, when practicable, if there is an omission of information that is required to be presented or disclosed.

**PASS KEY**

***Practicable*** means that the information is reasonably obtainable from management's accounts and records and that providing the information in the auditor's report does not require the auditor to assume the position of a preparer of financial information. For example, the auditor is not expected to prepare a basic financial statement, such as an omitted statement of cash flows, or segment information and include it in the auditor's report when management omits such information.

3. **Opinion Paragraph**

When the auditor expresses a qualified or adverse opinion, the opinion paragraph should have the heading "Qualified Opinion" or "Adverse Opinion," as appropriate.

a. **Qualified Opinion Paragraph** = Material GAAP

When the auditor expresses a qualified opinion due to a material misstatement in the financial statements, the opinion paragraph should state that, in the auditor's opinion, except for the effects of the matter(s) described in the basis for qualified opinion paragraph, the financial statements are presented fairly, in all material respects, in accordance with the applicable financial reporting framework.

b. **Adverse Opinion Paragraph** = Very material/pervasive GAAP

When the auditor expresses an adverse opinion, the opinion paragraph should state that, in the auditor's opinion, because of the significance of the matter(s) described in the basis for adverse opinion paragraph, the financial statements are not presented fairly in accordance with the applicable financial reporting framework.

Material GAAP problem

### 4. Sample Report—*Qualified Opinion* *Due to Inadequate Disclosure*

**INDEPENDENT AUDITOR'S REPORT**

*[Appropriate Addressee]*

We have audited the accompanying financial statements of ABC Company, which comprise the balance sheets as of December 31, 20X1 and 20X0, and the related statements of income, changes in stockholders' equity, and cash flows for the years then ended, and the related notes to the financial statements.

***Management's Responsibility for the Financial Statements***

Management is responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement whether due to fraud or error.

***Auditor's Responsibility***

Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our **qualified** audit opinion.

***Basis for Qualified Opinion***

**The Company's financial statements do not disclose [*describe the nature of the omitted information that is not practicable to present in the auditor's report*]. In our opinion, disclosure of this information is required by accounting principles generally accepted in the United States of America.**

***Qualified Opinion***

In our opinion, **except for the omission of the information described in the Basis for Qualified Opinion paragraph,** the financial statements referred to above present fairly, in all material respects, the financial position of ABC Company as of December 31, 20X1 and 20X0, and the results of its operations and its cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

*[Auditor's signature]*

*[Auditor's city and state]*

*[Date of the auditor's report]*

Material GAAP problem

### 5. Sample Report—*Qualified Opinion Due to a Material Misstatement of the Financial Statements*

**INDEPENDENT AUDITOR'S REPORT**

*[Appropriate Addressee]*

We have audited the accompanying financial statements of ABC Company, which comprise the balance sheets as of December 31, 20X1 and 20X0, and the related statements of income, changes in stockholders' equity, and cash flows for the years then ended, and the related notes to the financial statements.

***Management's Responsibility for the Financial Statements***

Management is responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement whether due to fraud or error.

***Auditor's Responsibility***

Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our **qualified** audit opinion.

***Basis for Qualified Opinion***

**The Company has stated inventories at cost in the accompanying balance sheets. Accounting principles generally accepted in the United States of America require inventories to be stated at the lower of cost or market. If the Company stated inventories at the lower of cost or market, a write down of $XXX and $XXX would have been required as of December 31, 20X1 and 20X0, respectively. Accordingly, costs of sales would have increased by $XXX and $XXX, and net income, income taxes, and stockholders' equity would have been reduced by $XXX, $XXX, and $XXX, and $XXX, $XXX, and $XXX, as of and for the years ended December 31, 20X1 and 20X0, respectively.**

***Qualified Opinion***

In our opinion, **except for the effects of the matter described in the Basis for Qualified Opinion paragraph,** the financial statements referred to above present fairly, in all material respects, the financial position of ABC Company as of December 31, 20X1 and 20X0, and the results of its operations and its cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

*[Auditor's signature]*

*[Auditor's city and state]*

*[Date of the auditor's report]*

Very material/pervasive GAAP problem

### 6. Sample Report—*Adverse Opinion Due to a Material Misstatement of the Financial Statements*

**INDEPENDENT AUDITOR'S REPORT**

*[Appropriate Addressee]*

We have audited the accompanying consolidated financial statements of ABC Company and its subsidiaries, which comprise the balance sheet as of December 31, 20X1, and the related consolidated statements of income, changes in stockholders' equity, and cash flows for the year then ended, and the related notes to the financial statements.

***Management's Responsibility for the Financial Statements***

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of consolidated financial statements that are free from material misstatement whether due to fraud or error.

***Auditor's Responsibility***

Our responsibility is to express an opinion on these consolidated financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our **adverse** audit opinion.

***Basis for Adverse Opinion***

**As described in Note X, the Company has not consolidated the financial statements of subsidiary XYZ Company that it acquired during 20X1 because it has not yet been able to ascertain the fair value of certain of the subsidiary's material assets and liabilities at the acquisition date. This investment is therefore accounted for on a cost basis by the Company. Under accounting principles generally accepted in the United States of America, the subsidiary should have been consolidated because it is controlled by the Company. Had XYZ Company been consolidated, many elements in the accompanying consolidated financial statements would have been materially affected. The effects on the consolidated financial statements of the failure to consolidate have not been determined.**

***Adverse Opinion***

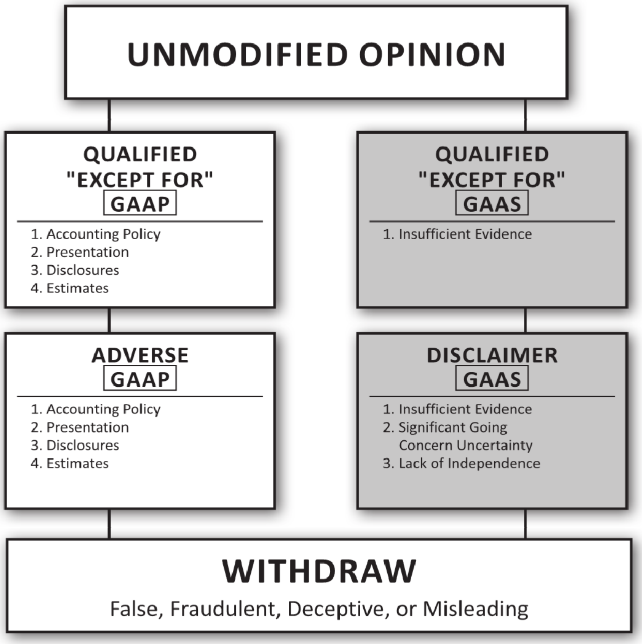
**In our opinion, because of the significance of the matter discussed in the Basis for Adverse Opinion paragraph, the consolidated financial statements referred to above do not present fairly the financial position of ABC Company and its subsidiaries as of December 31, 20X1, or the results of their operations or their cash flows for the year then ended.**

*[Auditor's signature]*

*[Auditor's city and state]*

*[Date of the auditor's report]*

## VII. GAAS ISSUES: QUALIFIED OPINION OR DISCLAIMER




GAAS problem

Material

Very material
(pervasive)
(significant)

### A. Qualified Opinion vs. Disclaimer

The auditor uses professional judgment to determine whether to issue a qualified opinion or a disclaimer of opinion due to a limitation on the scope of the audit. A scope limitation occurs when the auditor is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement.

- Uncertainty
- Scope limitation
- Independence
(unaudited)

| *Materiality of Problem* | *Financial Statements are Materially Misstated* *(GAAP Issues)* | *Inability to Obtain Sufficient Appropriate Audit Evidence* *(GAAS Issues)* |
|---|---|---|
| None or immaterial = | Unmodified | Unmodified |
| Material but not pervasive = | Qualified Opinion | Qualified Opinion |
| Material and pervasive = | Adverse Opinion | Disclaimer of Opinion |

#### 1. Qualified Opinion

A qualified opinion due to a GAAS problem should be expressed when the auditor is unable to obtain sufficient appropriate audit evidence on which to base an opinion and the auditor concludes that the possible effects of any undetected misstatements could be material but not pervasive.

#### 2. Disclaimer of Opinion

A disclaimer of opinion should be expressed when the auditor is unable to obtain sufficient appropriate audit evidence on which to base an opinion and the auditor concludes that the possible effects of any undetected misstatements could be both material and pervasive.

**U.S. AUDITING STANDARDS VS. INTERNATIONAL STANDARDS ON AUDITING**

ISAs require the auditor to disclaim an opinion when, in extremely rare circumstances involving multiple uncertainties, the auditor concludes that it is not possible to form an opinion on the financial statements due to the potential interaction of the uncertainties and their possible cumulative effect on the financial statements, even though the auditor has obtained sufficient appropriate audit evidence regarding the multiple uncertainties. U.S. GAAS does not include this requirement because, under U.S. GAAS, a disclaimer of opinion is only appropriate when the auditor is not able to gather sufficient, appropriate audited evidence.

## B. Causes of Scope Limitations

Limitations on the scope of the audit may be imposed by:

### 1. Circumstances

A scope limitation may be caused by circumstances beyond the control of the entity or circumstances relating to the nature or timing of the auditor's work. For example, a scope limitation may exist when an auditor was not engaged at the beginning of the year, when opening inventory should have been observed. When circumstances prevent the auditor from performing a specific procedure, the auditor should determine whether it is possible to perform alternative procedures.

- COGS = IS

- Time constraints

**PASS KEY**

The inability to perform a specific procedure is not a limitation on the scope of the audit if the auditor is able to obtain sufficient appropriate audit evidence by performing alternative procedures. If alternative procedures cannot be performed, the auditor should express a qualified opinion or a disclaimer of opinion.

### 2. Management

If the auditor becomes aware that management has imposed a limitation that the auditor believes may result in the need to express a qualified opinion or disclaim an opinion, the auditor should ask management to remove the limitation. If management will not remove the limitation, the auditor should communicate with those charged with governance and determine whether it is possible to perform alternative procedures.

Exam trick
Never adverse opinion

a. If the auditor is unable to obtain sufficient appropriate audit evidence due to a management-imposed scope limitation and the auditor concludes that the possible effects of any undetected misstatements could be both material and pervasive, then the auditor should either disclaim an opinion or withdraw from the engagement.

b. Withdrawal may not be possible if the auditor has substantially completed the audit, or if the audit is required by law or regulation. The auditor may choose to add an other-matter paragraph to the auditor's report to describe the reasons why the auditor cannot withdraw from an engagement when the auditor is unable to obtain sufficient appropriate audit evidence due to a management-imposed scope limitation and the possible effects on the financial statements of undetected misstatements could be both material and pervasive.

- Confirm A/R denied
- Consolidated sub info denied
- Audit restrictions
- Inadequate records
- No mgt. rep. letter signed
- Client lawyers denied

**U.S. AUDITING STANDARDS VS. INTERNATIONAL STANDARDS ON AUDITING**

ISAs require the auditor to withdraw from the audit when the auditor is unable to obtain sufficient appropriate audit evidence due to a management-imposed scope limitation and the auditor concludes that the possible effects of any undetected misstatements could be both material and pervasive. U.S. GAAS requires that the auditor consider withdrawal from the engagement under these circumstances.

## C. Form and Content of Auditor's Report

When the auditor expresses a qualified opinion or disclaimer of opinion, the "Auditor's Responsibility" paragraph is modified and the auditor's report will include a "Basis for Modification" paragraph and a "Qualified Opinion" or "Disclaimer of Opinion" paragraph, as appropriate. A disclaimer of opinion will also include a modification to the introductory paragraph of the auditor's report.

No change to "mgt. responsibility" paragraphs

1. **Modification of Introductory Paragraph—*Disclaimer Only***

   When an auditor expresses a disclaimer of opinion, the introductory paragraph is amended to state that the auditor was engaged to audit the financial statements.

2. **Modification of Auditor's Responsibility Paragraph**

   a. **Qualified Opinion** = Material GAAS problem

   When the auditor expresses a qualified opinion, the Auditor's Responsibility paragraph should be amended to state that the auditor believes that the audit evidence obtained is sufficient and appropriate to provide a basis for the auditor's qualified audit opinion.

   b. **Disclaimer of Opinion** = Very material/pervasive/significant GAAS problem

   When the auditor disclaims an opinion, the description of the auditor's responsibility and the scope of the audit should be amended to state only the following:

   Our responsibility is to express an opinion on the financial statements based on conducting the audit in accordance with auditing standards generally accepted in the United States of America. Because of the matter(s) described in the basis for disclaimer of opinion paragraph, however, we were not able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion.

3. **Basis for Modification Paragraph**

   The Basis for Modification paragraph should be placed immediately *before* the opinion paragraph, should use the heading "Basis for Qualified Opinion" or "Basis for Disclaimer of Opinion," as appropriate, and should describe the reasons for the inability to obtain sufficient appropriate audit evidence.

4. **Opinion Paragraph**

   When the auditor expresses a qualified opinion or a disclaimer of opinion, the opinion paragraph should have the heading "Qualified Opinion" or "Disclaimer of Opinion," as appropriate.

a. **Qualified Opinion Paragraph**

When the auditor expresses a qualified opinion due to an inability to obtain sufficient appropriate audit evidence, the opinion paragraph should state that, in the auditor's opinion, except for the possible effects of the matter(s) described in the basis for qualified opinion paragraph, the financial statements are presented fairly, in all material respects, in accordance with the applicable financial reporting framework.

**PASS KEY**

When the auditor expresses a qualified opinion due to a scope limitation, the opinion paragraph states that the qualification relates to the possible effect of the matter on the financial statements and not the scope limitation itself. Wording such as, "In our opinion, except for the above-mentioned limitation on the scope of the audit . . ." is not acceptable.

b. **Disclaimer of Opinion Paragraph**

When the auditor disclaims an opinion, the auditor should state in the opinion paragraph that:

(1) because of the significance of the matter(s) described in the basis for disclaimer of opinion paragraph, the auditor has not been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion; and

(2) accordingly, the auditor does not express an opinion on the financial statements.

**PASS KEY**

When the auditor is not independent but is required by law or regulation to report on the financial statements, the auditor should disclaim an opinion and should specifically state that the auditor is not independent. If the auditor chooses to provide the reasons for the lack of independence, the auditor should include all reasons.

Exam trick

No audit work = No audit opinion (not even a "bad" opinion)

Material GAAS problem

### 5. Sample Report—*Qualified Opinion Due to the Auditor's Inability to Obtain Sufficient Appropriate Audit Evidence*

**INDEPENDENT AUDITOR'S REPORT**

*[Appropriate Addressee]*

We have audited the accompanying financial statements of ABC Company, which comprise the balance sheets as of December 31, 20X1, and the related statements of income, changes in stockholders' equity, and cash flows for the year then ended, and the related notes to the financial statements.

***Management's Responsibility for the Financial Statements***

Management is responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement whether due to fraud or error.

***Auditor's Responsibility***

Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our **qualified** audit opinion.

***Basis for Qualified Opinion***

**ABC Company's investment in XYZ Company, a foreign affiliate acquired during the year and accounted for under the equity method is carried at $XXX on the balance sheet at December 31, 20X1, and ABC Company's share of XYZ Company's net income of $XXX is included in ABC Company's net income for the year then ended. We were unable to obtain sufficient appropriate audit evidence about the carrying amount of ABC Company's investment in XYZ Company as of December 31, 20X1 and ABC Company's share of XYZ Company's net income for the year then ended because we were denied access to the financial information, management, and the auditors of XYZ Company. Consequently, we were unable to determine whether any adjustments to these amounts were necessary.**

***Qualified Opinion***

In our opinion, **except for the possible effects of the matter described in the Basis for Qualified Opinion paragraph,** the financial statements referred to above present fairly, in all material respects, the financial position of ABC Company as of December 31, 20X1, and the results of its operations and its cash flows for the year then ended in accordance with accounting principles generally accepted in the United States of America.

*[Auditor's signature]*

*[Auditor's city and state]*

*[Date of the auditor's report]*

Very material
Pervasive



Significant GAAS problem

### 6. Sample Report—*Disclaimer of Opinion*

**INDEPENDENT AUDITOR'S REPORT**

*[Appropriate Addressee]*

**We were engaged to audit** the accompanying financial statements of ABC Company, which comprise the balance sheets as of December 31, 20X1, and the related statements of income, changes in stockholders' equity, and cash flows for the year then ended, and the related notes to the financial statements.

***Management's Responsibility for the Financial Statements***

Management is responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement whether due to fraud or error.

***Auditor's Responsibility***

**Our responsibility is to express an opinion on these financial statements based on conducting the audit in accordance with auditing standards generally accepted in the United States of America. Because of the matters described in the Basis for Disclaimer of Opinion paragraph, however, we were not able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion.**

***Basis for Disclaimer of Opinion***

**We were not engaged as auditors of the Company until after December 31, 20X1, and, therefore, did not observe the counting of physical inventories at the beginning or end of the year. We were unable to satisfy ourselves by other auditing procedures concerning the inventory held at December 31, 20X1, which is stated in the balance sheet at $XXX. In addition, the introduction of a new computerized accounts receivable system in September 20X1 resulted in numerous misstatements in accounts receivable. As of the date of our audit report, management was still in the process of rectifying the system deficiencies and correcting the misstatements. We were unable to confirm or verify by alternative means accounts receivable included in the balance sheet at a total amount of $XXX at December 31, 20X1. As a result of these matters, we were unable to determine whether any adjustments might have been found necessary in respect of recorded or unrecorded inventories and accounts receivable, and the elements making up the statements of income, changes in stockholder's equity, and cash flows.**

***Disclaimer of Opinion***

Because of the significance of the matters described in the Basis for Disclaimer of Opinion paragraph, we have not been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion. Accordingly, we do not express an opinion on these financial statements.

*[Auditor's signature]*

*[Auditor's city and state]*

*[Date of the auditor's report]*

**PASS KEY**

A commonly tested area is the concept of uncertainty. The chart below will assist you in mastering this area.

| Uncertainty | | |
|---|---|---|
| No Material Misstatement and Sufficient Evidence | GAAP Material Misstatement Related to the Uncertainty | GAAS Insufficient Evidence (Scope Limitation) |
| Unmodified | Qualified or Adverse | Qualified or Disclaimer |

**AUDITOR'S REPORT SUMMARY**

| | *Type of Opinion* | *Intro Paragraph* | *Management Responsibility Paragraph* | *Auditor Responsibility Paragraph* | *Basis for Opinion Paragraph* | *Opinion Paragraph* | *Emphasis-of-Matter Paragraph* |
|---|---|---|---|---|---|---|---|
| ***1. Group Audit*** | | | | | | | |
| *Make Reference* | Unmodified | Standard | Standard | We did not audit . . . | No | Report of other auditors . . . | No |
| *Assume Responsibility* | Unmodified | Standard | Standard | Standard | No | Present fairly | No |
| ***2. Going Concern*** | | | | | | | |
| *Adequate disclosure* | Unmodified | Standard | Standard | Standard | No | Present fairly | Yes |
| *Inadequate disclosure (material misstatement)* GAAP | Qualified/Adverse | Standard | Standard | Name type of modified opinion | Yes | Except for/ Do not present fairly | Yes |
| *Significant going concern uncertainty* GAAS | Disclaimer | Engaged to audit | Standard | Not able to obtain . . . | Yes | Disclaimer | No |
| ***3. Justified Lack of Consistency*** | Unmodified | Standard | Standard | Standard | No | Present fairly | Yes |
| ***4. Misstatement*** GAAP | | | | | | | |
| *Immaterial* | Unmodified | Standard | Standard | Standard | No | Present fairly | No |
| *Material but not pervasive* | Qualified | Standard | Standard | Name type of modified opinion | Yes | Except for | No |
| *Material and pervasive* | Adverse | Standard | Standard | Name type of modified opinion | Yes | Do not present fairly | No |
| ***5. Scope Limitation*** GAAS | | | | | | | |
| *Immaterial* | Unmodified | Standard | Standard | Standard | No | Present fairly | No |
| *Material but not pervasive* | Qualified | Standard | Standard | Name type of modified opinion | Yes | Except for | No |
| *Material and pervasive* | Disclaimer | Engaged to audit | Standard | Not able to obtain . . . | Yes | Disclaimer | No |
| ***6. Uncertainty*** | | | | | | | |
| *No material misstatement & sufficient evidence* | Unmodified | Standard | Standard | Standard | No | Present fairly | May be necessary |
| *Material misstatement* GAAP | Qualified/Adverse | Standard | Standard | Name type of modified opinion | Yes | Except for/ Do not present fairly | No |
| *Insufficient evidence (scope limitation)* GAAS | Qualified/Disclaimer | Engaged to audit | Standard | Name type of modified opinion/ Not able to obtain. . . | Yes | Disclaimer | No |

# REPORTS ON COMPARATIVE FINANCIAL STATEMENTS

## I. INTRODUCTION

Comparative Financial Statements

When comparative financial statements are presented, the auditor's report should refer to each period for which financial statements are presented and on which an audit opinion is expressed. Since the report date for the audit of the most recent financial statements is used, the auditor should update the audit reports on financial statements previously issued. Update can mean reaffirm or it can mean change the original opinion as a result of changed conditions or information coming to the auditor's attention during the current engagement. If comparative information is presented but not covered by the auditor's opinion, the auditor should indicate clearly in the auditor's report the character of the auditor's work, if any, and the degree of responsibility the auditor is taking.

## II. REPORTING WITH DIFFERENT OPINIONS

The auditor's current year report will generally cover all financial statements for all years presented. The auditor may express a qualified or adverse opinion, disclaim an opinion, or include an emphasis-of-matter or other-matter paragraph with respect to one or more financial statements for one or more periods, while expressing a different opinion on one or more financial statements of another period presented. Some examples of varying opinions are included below.

### A. Sample Report—*Unmodified Prior Year With Current Year Qualified*

**INDEPENDENT AUDITOR'S REPORT**

[*Appropriate Addressee*]

We have audited the accompanying financial statements of ABC Company, which comprise the balance sheets as of December 31, 20X1 and 20X0, and the related statements of income, changes in stockholders' equity, and cash flows for the years then ended, and the related notes to the financial statements.

***Management's Responsibility for the Financial Statements***

Management is responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement whether due to fraud or error.

***Auditor's Responsibility***

Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

(continued)

(continued)

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our **qualified** audit opinion.

***Basis for Qualified Opinion***

**The company has excluded, from property and debt in the accompanying 20X1 balance sheet, certain capital lease obligations that were entered into in 20X1 which, in our opinion, should be capitalized in accordance with accounting principles generally accepted in the United States of America. If these lease obligations were capitalized, property would be increased by $XXX, long-term debt by $XXX, and retained earnings by $XXX as of December 31, 20X1, and net income and earnings per share would be increased (decreased) by $XXX and $XXX, respectively, for the year then ended.**

***Qualified Opinion***

In our opinion, **except for the effects on the 20X1 financial statements of not capitalizing certain lease obligations as described in the Basis for Qualified Opinion paragraph**, the financial statements referred to above present fairly, in all material respects, the financial position of ABC Company as of December 31, 20X1 and 20X0, and the results of its operations and its cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

[*Auditor's signature*]

[*Auditor's city and state*]

[*Date of the auditor's report*]

## B. Sample Report—*Unmodified Current Year With Disclaimer on Prior Year Statements of Income, Changes in Stockholders' Equity, and Cash Flows*

INDEPENDENT AUDITOR'S REPORT

[*Appropriate Addressee*]

We have audited the accompanying financial statements of ABC Company, which comprise the balance sheets as of December 31, 20X2 and 20X1, and the related statements of income, changes in stockholders' equity, and cash flows for the years then ended, and the related notes to the financial statements.

***Management's Responsibility for the Financial Statements***

Management is responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement whether due to fraud or error.

***Auditor's Responsibility***

Our responsibility is to express an opinion on these financial statements based on our audits. **Except as explained in the Basis for Disclaimer of Opinion paragraph**, we conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

(continued)

(continued)

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

**We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinions on the balance sheets as of December 31, 20X2 and 20X1, and the statements of income, changes in stockholders' equity, and cash flows for the year ended December 31, 20X2.**

~~20X1~~

***Basis for Disclaimer of Opinion on 20X1 Operations and Cash Flows***

Like a scope limitation

**We did not observe the taking of the physical inventory as of December 31, 20X0, since that date was prior to our engagement as auditors for the Company, and we were unable to satisfy ourselves regarding inventory quantities by means of other auditing procedures. Inventory amounts as of December 31, 20X0 enter into the determination of net income and cash flows for the year ended December 31, 20X1.**

***Disclaimer of Opinion***

GAAS

**Because of the significance of the matter described in the Basis for Disclaimer of Opinion paragraph, we have not been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion on the results of operations and cash flows for the year ended December 31, 20X1. Accordingly, we do not express an opinion on the results of operations and cash flows for the year ended December 31, 20X1.**

***Opinion***

Disclaimer

In our opinion, the balance sheets of ABC Company as of December 31, 20X2 and 20X1, and the statements of income, changes in stockholders' equity, and cash flows for the year ended December 31, 20X2, present fairly, in all material respects, the financial position of ABC Company as of December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the year ended December 31, 20X2 in accordance with accounting principles generally accepted in the United States of America.

[*Auditor's signature*]

[*Auditor's city and state*]

[*Date of the auditor's report*]

**PASS KEY**

When the prior year's financial statements were not audited and the current year's financial statements are being audited, the auditor is in essence facing a scope limitation. The beginning balances may not be ascertainable and therefore a disclaimer of opinion on the statements of income, retained earnings, and cash flows may be required.

## III. UPDATING (CHANGING) PRIOR OPINIONS

**Updated Opinion**

If, during the current examination, the auditor becomes aware of evidence that affects the prior statements and the opinion that was expressed, the auditor should update the opinion in the current year's report.

**EXAMPLE**

A previous report that was qualified due to a departure from GAAP would no longer be appropriate in the event of the restatement of the prior year's financial statements.

### A. Format

If the updated opinion differs from the previous opinion, the auditors should disclose the reason(s) in an *emphasis-of-matter* or *other-matter paragraph* that discloses the following:

Updated/changed opinion

D 1. **D**ate of the auditor's previous report

O 2. **O**pinion type previously issued

R 3. **R**eason for the prior opinion

C 4. **C**hanges that have occurred

S 5. **S**tatement that the "opinion…is different."

When now in conformity with GAAP

| Emphasis-of-Matter |
|---|
| Going Concern |
| Consistency |
| Changing Prior Opinion |
| Special Purpose Framework |

OR

**Other-Matter Paragraph**

**PASS KEY**

Remember, only "DORCS" change their mind.

### B. Sample Other-Matter Paragraph

***Other Matter***

D O R C S

In our report dated March 1, 20X1, we expressed an opinion that the 20X0 financial statements did not fairly present the financial position, results of operations, and cash flows of ABC Company in accordance with accounting principles generally accepted in the United States of America because of two departures from such principles: (1) ABC Company carried its property, plant, and equipment at appraisal values, and provided for depreciation on the basis of such values, and (2) ABC Company did not provide for deferred income taxes with respect to differences between income for financial reporting purposes and taxable income. As described in Note X, the Company has changed its method of accounting for these items and restated its 20X0 financial statements to conform with accounting principles generally accepted in the United States of America. Accordingly, our present opinion on the restated 20X0 financial statements, as presented herein, is different from that expressed in our previous report.

## IV. PRIOR PERIOD FINANCIAL STATEMENTS AUDITED BY A PREDECESSOR AUDITOR

### A. Report of the Predecessor Auditor Presented

Predecessor auditors may reissue their report on financial statements as long as the report is still appropriate. However, the current presentation of the prior period statements or the occurrence of subsequent events may make the previous report inappropriate. In deciding whether to reissue their report, the predecessor auditors should:

Prior (old) CPA should

1. Read the statements for the current period.
2. Compare the statements audited with the current period statements.
3. Obtain a letter of representation from the successor auditor. The representation letter should state whether the successor auditor's audit revealed any matters that, in the successor auditor's opinion, might have a material effect on, or require disclosure in, the statements reported on by the predecessor auditor.
4. Inquire of and obtain a letter of representation from management at or near the date of reissuance. The representation letter should state whether management believes that any of the previous management representations need to be modified and whether there have been any subsequent events requiring adjustment to or disclosure in the reissued financial statements.
5. Date the report as appropriate:

   **1. Unrevised**

   Use the original report date in any reissue of a previous report, since the predecessor auditor has limited knowledge of the former client's current status.

   **2. Revised**

   Dual date (covered later) is used in the event that the predecessor auditor revises the report.

### B. Report of the Predecessor Auditor Not Reissued

**Other-Matter Paragraph**

When the successor auditor does not present the predecessor auditor's report, the successor auditor should express an opinion on the current period financial statements only and indicate in an *other-matter paragraph*:

Current (new) CPA should

1. That the financial statements of the prior period were audited by a predecessor auditor. The predecessor auditors should not be named unless the practice of the predecessors was acquired by or merged with that of the successor.
2. The type of opinion expressed by the predecessor auditor and, if the opinion was modified, the reasons for the modification.
3. The nature of any emphasis-of-matter or other-matter paragraph included in the predecessor auditor's report.
4. The date of the predecessor auditor's report.

If the prior period financial statements are restated and the predecessor agrees to issue a new auditor's report on the restated financial statements of the prior period, the successor auditor should express an opinion only on the current period.

## V. PRIOR PERIOD FINANCIAL STATEMENTS NOT AUDITED

### A. Prior Period Statements Reviewed or Compiled

Other-Matter Paragraph

When the current period financial statements are audited and presented in comparative form with prior period financial statements that were reviewed or compiled, and the report of the prior period is not reissued, the auditor should include an *other-matter paragraph* in the auditor's report that includes:

1. the service (review or compilation) performed in the prior period;
2. the date of the prior period report;
3. a description of any material modifications described in the report; and
4. a statement that the service was less in scope than an audit and does not provide the basis for expressing an opinion on the financial statements.

### B. Prior Period Statements Not Audited, Reviewed or Compiled

If the prior period statements were not audited, reviewed or compiled, the financial statements should be clearly marked, and the auditor's report should include an other-matter paragraph to indicate that the auditor did not audit, review or compile the prior period financial statements and that the auditor assumes no responsibility for them.

| **OPINION WRITING FORMAT SUMMARY** | | | |
|---|---|---|---|
| | *Audit Opinion* | *Comparative—Different Opinions* | *Comparative—Updated Opinion* |
| *Title* | Independent Auditor's Report | Independent Auditor's Report | Independent Auditor's Report |
| *Addressee* | As required by circumstances | As required by circumstances | As required by circumstances |
| *Intro Paragraph—Service* | Audited | Audited | Audited |
| *Intro Paragraph—Financial Statements* | Balance Sheet<br>Income Statement<br>Statement of Changes in Equity<br>Statement of Cash Flows | Balance Sheet<br>Income Statement<br>Statement of Changes in Equity<br>Statement of Cash Flows | Balance Sheet<br>Income Statement<br>Statement of Changes in Equity<br>Statement of Cash Flows |
| *Intro Paragraph—Period(s)* | Single or Comparative Periods | Comparative Periods | Comparative Periods |
| *Mgt. **R**esponsibility Paragraph* | Financial Statements<br>Internal Controls | Financial Statements<br>Internal Controls | Financial Statements<br>Internal Controls |
| *Auditor's **R**esponsibility Paragraph* | **M**gt. **R**esp. **C**ontrol<br>**R**esp. **E**xpress **R**eason<br>**P**lan **A**cct.<br>**D**esign **P**erf. **M**gt.<br>**I**mpl. **O**btain **E**val.<br>**M**ain **R**isk<br>**T**est<br>**S**tate | **M R C**<br>**R E R**<br>**P A**<br>**D P M**<br>**I O E**<br>**M R**<br>**T**<br>**S** | **M R C**<br>**R E R**<br>**P A**<br>**D P M**<br>**I O E**<br>**M R**<br>**T**<br>**S** |
| *Opinion Paragraph* | Opinion—Present fairly in accordance with framework | Both Opinions | Both Opinions |
| *Emphasis-of-Matter Paragraph* | | | **D**ate<br>**O**pinions<br>**R**eason<br>**C**hanges<br>**S**tatement—Opinion different |
| *Auditor's Signature* | CPA firm (manual or printed) | CPA firm (manual or printed) | CPA firm (manual or printed) |
| *Auditor's Address* | City and state | City and state | City and state |
| *Report Date* | Sufficient appropriate evidence obtained | Sufficient appropriate evidence obtained | Sufficient appropriate evidence obtained |

# EVENTS OCCURRING AFTER YEAR-END

## I. SUBSEQUENT EVENTS

Subsequent Events

Events or transactions that occur after the balance sheet date, but before the financial statements are issued, are known as subsequent events. A subsequent event may require adjustment to the financial statements or may require disclosure of an event without adjustment to the financial statements. U.S. GAAP identifies two types of subsequent events:

### A. Recognized (Type I) Events—*Conditions Existing On or Before the Balance Sheet Date*

$ recorded (looking back)

An adjustment to the financial statements is usually required if the condition existed at the date of the financial statements. A trade receivable existing at the date of the financial statements that is deemed uncollectible because of bankruptcy of the customer requires an adjustment to the financial statements.

### B. Nonrecognized (Type II) Events—*Conditions Existing After the Balance Sheet Date*

Footnote (looking forward)

Significant business events, such as the purchase of a business or the sale of debenture bonds, occurring subsequent to the date of financial statements, require no adjustment to the financial statements, but may require significant additional disclosure. These types of events may require only disclosure by a note to the financial statements or could require complete supplemental disclosure such as pro forma financial statements. *However, they rarely require an actual adjustment to the financial statements for the period*. The auditor exercises judgment as to whether or not mentioning the subsequent event would cause the financial statements to be misleading.

**PASS KEY**

When testing the issue of subsequent events, a candidate is expected to know the GAAP rules:

- Recognized (Type I) Event → Requires a financial statement adjustment
- Nonrecognized (Type II) Event → May require footnote disclosure

GR: CPA responsible → up to date of audit report

### C. Auditor's Responsibility for Subsequent Events

During fieldwork

The period between the date of the financial statements and the date of the auditor's report is called the subsequent period. During this period, the auditor has an active responsibility to investigate certain subsequent events. *During the subsequent period,* the auditor should obtain an understanding of the procedures management has established to identify subsequent events and should perform the following procedures:

P 1. Post balance sheet transactions: Review for proper cutoff and to better evaluate year-end balances.

R 2. Representation letter should be obtained from management (usually the CEO and CFO) regarding whether any events occurred during the subsequent period that require adjustments to or disclosure in the financial statements.

I 3. Inquiry.

a. Inquire of management and those charged with governance about whether any subsequent events have occurred that could effect the financial statements. Specific inquiries should be made about the following matters:

(1) New commitments, borrowings, or guarantees

(2) Sales or acquisitions of assets

(3) Increases in capital or issuances of debt

(4) Assets appropriated by the government or destroyed

(5) Developments regarding contingencies

(6) Unusual accounting adjustments

(7) Events that call into question the appropriateness of the entity's accounting policies

(8) Events relevant to the measurement of estimates or provisions

(9) Events relevant to the recoverability of assets

b. Inquire of client's legal counsel concerning litigation, claims, and assessments.

M

4. Minutes of stockholders, directors, and other committee meetings should be read during the subsequent period.

E

5. Examine latest available interim financial statements; compare them with the financial statements under audit.

**D. Auditor's Responsibility After the Original Date of the Auditor's Report**

The auditor has no active responsibility to make any inquiries or to perform any further auditing procedures to discover subsequent events after the original date of the auditor's report. However, if the auditor becomes aware of any information relating to subsequent events before the report release date, the auditor should consider whether it is necessary to adjust the financial statements or the related disclosures.

GAAP issue

**PASS KEY**

If the auditor believes that the financial statements need to be revised to reflect a subsequent event and management does not make the revision, the auditor should express a qualified or adverse opinion.

**1. Report Date**

a. If adjustments or disclosures are made after the original date of the auditor's report, the auditor may dual date the report to extend responsibility only for the particular subsequent event. The original date of the report is retained for the rest of the financial statements.

Dual dating

(1) Example of dual dating: "January 21, 20X2, except as to Note 2, which is as of February 3, 20X2."

b. Alternatively, a later date may be used for the report, but this extends the auditor's responsibility for all subsequent events to this later date.

**U.S. AUDITING STANDARDS VS. INTERNATIONAL STANDARDS ON AUDITING**

ISA 560 states that when management amends the financial statements for facts discovered after the date of the report but before the date the financial statements are issued, the auditor should provide management with a new report dated no earlier than the date of approval of the amended financial statements. In such circumstances, the auditor would perform procedures designed to obtain evidence that all events up to the new report date that may require adjustment of, or disclosure in, the financial statements have been identified. If management is permitted by law, regulation, or financial reporting framework to limit the amendment of the financial statements to the effects of the subsequent event, the auditor may limit the subsequent event audit procedures to the amendment and either dual-date the audit report or provide a new or amended audit report that includes a statement in an emphasis-of-matter paragraph or other-matter paragraph that the auditor's subsequent events procedures were limited to the amendment of the financial statements.

## E. Audit Timing

The following chart shows the timing for a typical audit.

**AUDIT - TIME BUDGET OF 2,000 HOURS**

FACTS: The year end is Dec. 31, 20X1. The report is due Feb. 15, 20X2.

| | | | |
|---|---|---|---|
| **JUNE 1** ↓ **TO** ↓ **OCT 20** | 1,600 Hrs | INTERIM WORK | **DETAIL WORK**<br>Confirms of: cash, AR, NR, etc.<br>Cash reconciliations<br>Special account analysis<br>Physical inventory observation<br>Fixed asset verification<br>Tests of sales and payroll<br>Internal control review |
| **DEC 27 – JAN 3** | 80 | CUTOFFS | Year end inventory observation and cutoff tests of cash, AR, inventory, AP, sales, etc. |
| | | ↑ Client closes books ↓ | |
| **JAN 15 – FEB 10**<br>Auditor IS responsible<br>(Feb 10 = date of auditor's report) | 300 | YE – WORK includes "PRIME" | Review of subsequent AR collections<br>Follow up on confirm request<br>Search for unrecorded liabilities<br>Subsequent events audit program: "PRIME" |
| ↑ Auditor is NOT responsible ↓ | | | |
| **FEB 15** Report issued | 20 | REPORT | Obtain management representation letter (dated Feb 10) at last minute |

## II. SUBSEQUENT DISCOVERY OF FACTS AFTER THE REPORT RELEASE DATE

Subsequent Discovery of Facts

We missed something

Usually, an auditor has no obligation to make continuing inquiries after the date of the report. However, if an auditor becomes aware of material information that would have affected the report, and that persons are currently relying or are likely to rely on the financial statements covered by the report, the auditor should take appropriate action.

### A. Auditor Action

Upon discovering, after issuance of the report, information (confirmed by the auditor) that materially affects the report and other persons' reliance on it, the auditor should advise the client to immediately disclose the new information and its impact on the financial statements to persons currently relying or likely to rely on the financial statements. This may be accomplished by:

1. Advising the client to issue revised financial statements (along with a new audit report) describing the reasons for revision.
   a. If the auditor's opinion on the revised financial statements differs from the opinion previously expressed, this should be disclosed in an emphasis-of-matter or other-matter paragraph.
2. Advising the client to make the necessary disclosures and revisions to any imminent financial statements (accompanied by an auditor's report for a subsequent period); or
3. If the effect on the financial statements cannot be determined on a timely basis, providing notification that the financial statements and auditor's report should not be relied upon. In addition, the client should be advised to discuss with the SEC, stock exchanges, and appropriate regulatory agencies (where applicable) the new disclosures or revisions.

Regardless of which disclosure method above is used, the auditor must become satisfied that appropriate steps have been taken by the client.

### B. If Client Refuses to Follow Procedures

If the client refuses to proceed as above, the auditor should notify each member of the board of directors of such refusal, and of the fact that the auditor will take additional steps to prevent further reliance on the auditor's report and the financial statements.

1. **Additional Steps to Prevent Further Reliance** = "DAR" them to fix it
   a. Disassociate — Notify the client that the auditor's report must no longer be associated with the financial statements;
   b. Alert agencies — Notify, if applicable, any regulatory agencies having jurisdiction over the client that the auditor's report should no longer be relied on; and
   c. Relying parties — Notify persons known to be relying or likely to rely on the financial statements that the auditor's report should no longer be relied on.

2. **Notification**

   Any notification to parties other than the client should be as precise and factual as possible, and should contain a description of the effect that the discovered information would have had on the auditor's report on the financial statements.

   If the client has refused to cooperate, and as a result the auditors were unable to conduct an adequate investigation of the information, the auditors' disclosure need only state that information has come to their attention and that, if the information is true, their report should no longer be relied upon.

   The auditors should use their professional judgment in the circumstances described above, and it may be advisable to consult legal counsel.

## III. OMITTED AUDIT PROCEDURES DISCOVERED AFTER SUBMISSION OF THE AUDIT REPORT

**Omitted Audit Procedures**

Omitted audit procedures may be discovered (after the audit report has been submitted) during a firm's internal inspection program or during peer review.

We forgot to do it

### A. Auditor Action

1. The auditor should determine whether other audit procedures were adequate to compensate for the omitted audit procedures. If so, no further action is necessary.

Better late than never

2. If, on the other hand, the omitted audit procedures impair the auditor's ability to support the previously issued opinion, and there are people relying (or likely to rely) on the report, then the auditor should promptly undertake to apply the omitted procedures (or alternative procedures).

3. If facts emerge that would have affected the auditor's report, the auditor should proceed as described under subsequent discovery of facts.

# REPORTING ON OTHER INFORMATION

## I. OTHER INFORMATION IN DOCUMENTS CONTAINING AUDITED FINANCIAL STATEMENTS

### A. Auditor's Responsibility

Frequently, audited financial statements are incorporated into other documents, such as annual reports to shareholders or reports by charitable organizations to the general public. Generally, an auditor is not responsible for determining whether other information in documents containing the audited financial statements and the auditor's report is properly stated. However, the auditor should read the other information because the credibility of the audited financial statements may be undermined if there are material inconsistencies between the audited financial statements and the other information.

#### 1. Other Information

Other information includes:

a. A report by management or those charged with governance on operations

b. Financial summaries or highlights

c. Employment data

d. Planned capital expenditures

e. Financial ratios

f. Names of officers and directors

g. Selected quarterly data

Other information does not include press releases or cover letters accompanying the document containing the audited financial statements and the auditor's report, information contained in analyst briefings, or information contained on the entity's website.

#### 2. Material Inconsistency

The document containing the audited financial statements may contain other information that is materially inconsistent with the financial statements. If the auditor identifies a material inconsistency, the auditor should determine whether the audited financial statements or the other information needs to be revised.

**a. Audited Financial Statements Require Revision**

If the audited financial statements require revision for a material inconsistency and management refuses to make the revision, the auditor should modify the audit opinion.

**b. Other Information Requires Revision**

**Other-Matter Paragraph**

If the other information requires revision for a material inconsistency and management refuses to make the revision, the auditor should communicate this matter with those charged with governance and:

(1) include in the auditor's report an *other-matter paragraph* describing the material inconsistency;

(2) withhold the use of the report; or

(3) withdraw from the engagement and consult with legal counsel.

False/fraudulent/deceptive/misleading

3. **Material Misstatement of Fact**

Other information may include a material misstatement of fact that is unrelated to financial statement data. If the auditor becomes aware of a material misstatement of fact after reading the other information, the auditor should discuss the matter with management. If management refuses to take corrective action, the auditor should request that management consult with a qualified third party, such as the entity's legal counsel, and the auditor should consider the advice received from the third party in determining whether the matter is a material misstatement of fact. When the auditor concludes that there is a material misstatement of fact that management refuses to correct, the auditor should notify those charged with governance.

**B. Disclaimer of Opinion on Other Information** *(optional)*

**Other-Matter Paragraph**

The auditor is not required to reference the other information in the audit report on the financial statements. However, the auditor may choose to include an *other-matter paragraph* disclaiming an opinion on the other information:

> ***Other Matter***
>
> Our audit was conducted for the purpose of forming an opinion on the basic financial statements as a whole. The [*identify the other information*] is presented for purposes of additional analysis and is not a required part of the basic financial statements. Such information has not been subjected to the auditing procedures applied in the audit of the basic financial statements and, accordingly, we do not express an opinion or provide any assurance on it.

## II. REPORTING ON SUPPLEMENTARY INFORMATION IN RELATION TO THE FINANCIAL STATEMENTS AS A WHOLE

**A. Definition**

Supplementary information is information presented outside the basic financial statements that may be presented in a document containing the audited financial statements or separate from the financial statements.

**B. Reporting on Supplementary Information**

An auditor may be engaged to report on supplementary information in relation to the financial statements as a whole. The auditor has two objectives in such engagements:

1. to evaluate the presentation of the supplementary information in relation to the financial statements as a whole; and
2. to report on whether the supplementary information is fairly stated, in all material respects, in relation to the financial statements as a whole.

**C. Conditions for Reporting**

In order to issue an opinion on whether the supplementary information is fairly stated in all material respects in relation to the financial statements as a whole, the auditor must determine that the following conditions are met:

1. the information was derived from or relates directly to the information used to prepare the financial statements;
2. the information relates to the same period as the financial statements;
3. the financial statements were audited and the auditor issued an auditor's report;

4. neither an adverse opinion nor a disclaimer of opinion was issued on the financial statements; and

5. the supplementary information will accompany the audited financial statements or the audited financial statements will be made readily available by the entity.

## D. Management Responsibility

The auditor must obtain an agreement of management that it acknowledges and understands its responsibilities to:

1. prepare the information in accordance with applicable criteria;
2. provide the auditor with written representations related to the information;
3. include the auditor's report on the supplementary information in any document that contains the information; and
4. present the information with the audited financial statements or make the audited financial statements readily available to the intended users of the supplementary information by the issuance date of the supplementary information and auditor's report.

## E. Audit Procedures

In addition to the procedures performed during the audit of the financial statements, the auditor should perform the following audit procedures using the same materiality level used in the financial statement audit:

1. Inquire of management regarding the purpose of the supplementary information and the criteria used to prepare the information.
2. Determine whether the form and content of the information complies with the applicable criteria.
3. Obtain an understanding of the methods used to prepare the information, and any changes from the methods used in the prior periods, including the reasons for the changes.
4. Compare and reconcile the information to the audited financial statements and underlying accounting records.
5. Inquire regarding any significant assumptions underlying the preparation or presentation of the information.
6. Evaluate the appropriateness and completeness of the information.
7. Obtain written representations from management regarding the information.

The auditor has no responsibility to consider subsequent events with respect to supplementary information.

**PCAOB STANDARDS—GUIDANCE FOR ISSUERS**

PCAOB standards include the following additional requirements for audit procedures:

- Evaluate the **appropriateness** of methods used to prepare the supplemental information. If the methods have changed, evaluate the **appropriateness** of such changes.
- Determine that the supplemental information reconciles to the underlying accounting and **other records** or to the financial statements, as applicable.
- The auditor generally should use the same materiality considerations as those used in planning and performing the audit of the financial statements, except if an applicable regulatory requirement specifies **a lower materiality level** to be applied to certain supplemental information.

PCAOB standards include the following additional requirements for evaluation of audit results for supplementary information:

- The auditor should evaluate whether the supplemental information, including its form and content, is fairly stated, in all material respects, in relation to the financial statements as a whole, including whether the supplemental information is presented in conformity, in all material respects, with the relevant regulatory requirements or other applicable criteria.
- The auditor should accumulate misstatements on the supplemental information. These misstatements should be communicated to management on a timely basis to provide management with an opportunity to correct them.
- The auditor should evaluate whether uncorrected misstatements related to the supplemental information are material, either individually or in combination with other misstatements, taking into account relevant quantitative and qualitative factors. The auditor should evaluate the effect of uncorrected misstatements related to the supplemental information in evaluating the results of the financial statement audit.

## F. Reporting for Nonissuers

(Private company)

**Other-Matter Paragraph**

The auditor's report on the supplementary information may either be presented as an *other-matter paragraph* in the auditor's report on the financial statements or in a separate report.

### 1. Sample Other-Matter Paragraph

***Other Matter***

Our audit was conducted for the purpose of forming an opinion on the financial statements as a whole. The [identify accompanying supplementary information] is presented for purposes of additional analysis and is not a required part of the financial statements. Such information is the responsibility of management and was derived from and relates directly to the underlying accounting and other records used to prepare the financial statements. The information has been subjected to the auditing procedures applied in the audit of the financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the financial statements or to the financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In our opinion, the information is fairly stated in all material respects in relation to the financial statements as a whole.

OR

### 2. Separate Report

When reporting separately, the report should include a reference to the report on the financial statements, the date of that report, the nature of the opinion on the financial statements, and any report modifications. The auditor may also consider including an alert that restricts the use of the separate report solely to the appropriate specified parties to avoid potential misinterpretation or misunderstanding of the supplementary information that is not presented with the financial statements.

3. **Report Date**

   The date of the auditor's report should not be earlier than the date that the required procedures were completed.

4. **Forming an Opinion on Supplementary Information**

   a. **Material Misstatement of Supplementary Information**

      If the auditor concludes that the supplementary information is materially misstated in relation to the financial statements as a whole and management refuses to revise the information, that auditor should:

      (1) Modify the opinion on the supplementary information (qualified or adverse) and describe the misstatement.

      (2) If a separate report is being issued on the supplementary information, withhold the report.

   b. **Effect of Modifications to the Audit Report on the Financial Statements When Forming an Opinion on the Supplemental Information**

      (1) When the auditor expresses a qualified opinion on the financial statements and the basis for the qualification also applies to the supplemental information, the auditor should describe the effects of the qualification on the supplemental information in the report on supplemental information and should express a qualified opinion on the supplemental information.

      (2) When the auditor's report on the audited financial statements contains an adverse opinion or a disclaimer of opinion and the auditor has been engaged to report on supplementary information, the auditor is prohibited from expressing an opinion on the supplementary information.

## G. Reporting for Issuers (Public company)

Unless prescribed by regulatory requirements, the auditor may either include the auditor's report on the supplemental information in the auditor's report on the financial statements, or issue a separate report on the supplemental information. If the auditor issues a separate report on the supplemental information, that report should identify the auditor's report on the financial statements.

1. **Sample Auditor's Report on Supplemental Information When Included in the Auditor's Report on the Financial Statements**

> The [*identify supplemental information*] has been subjected to audit procedures performed in conjunction with the audit of [*Company's*] financial statements. The [*supplemental information*] is the responsibility of the Company's management. Our audit procedures included determining whether the [*supplemental information*] reconciles to the financial statements or the underlying accounting and other records, as applicable, and performing procedures to test the completeness and accuracy of the information presented in the [*supplemental information*]. In forming our opinion on the [*supplemental information*], we evaluated whether the [*supplemental information*], including its form and content, is presented in conformity with [*specify the relevant regulatory requirement or other criteria, if any*]. In our opinion, the [*identify supplemental information*] is fairly stated, in all material respects, in relation to the financial statements as a whole.

2. **Report Date**

The date of the auditor's report on the supplemental information in relation to the financial statements as a whole should not be earlier than:

a. the date of the auditor's report on the financial statements from which the supplemental information was derived; and

b. the date on which the auditor obtained sufficient appropriate audit evidence to support the auditor's opinion on the supplemental information in relation to the financial statements as a whole

3. **Forming an Opinion on Supplementary Information**

GAAP problem

a. **Material Misstatements of Supplementary Information**

If the auditor determines that the supplemental information is materially misstated in relation to the financial statements as a whole, the auditor should describe the material misstatement in the auditor's report on the supplemental information and express a qualified or adverse opinion on the supplemental information.

GAAS problem

b. **Inability to Obtain Sufficient Appropriate Audit Evidence for Supplementary Information**

If the auditor is unable to obtain sufficient appropriate audit evidence to support an opinion on the supplemental information, the auditor should disclaim an opinion on the supplemental information. In those situations, the auditor's report on the supplemental information should describe the reason for the disclaimer and state that the auditor is unable to and does not express an opinion on the supplemental information.

c. **Effect of Modifications to the Audit Report on the Financial Statements When Forming an Opinion on the Supplemental Information**

(1) When the auditor expresses a qualified opinion on the financial statements and the basis for the qualification also applies to the supplemental information, the auditor should describe the effects of the qualification on the supplemental information in the report on supplemental information and should express a qualified opinion on the supplemental information.

(2) When the auditor expresses an adverse opinion or disclaims an opinion on the financial statements, the auditor should also express an adverse opinion or disclaim an opinion on the supplemental information, as appropriate.

# III. REQUIRED SUPPLEMENTARY INFORMATION

Required Supplementary Information

## A. General

Certain entities are required by a designated standard setter to prepare specific information that is supplementary to the basic financial statements. In the absence of any separate requirement particular to the engagement, the auditor's opinion on the financial statements does not cover the required supplementary information.

## B. Required Procedures

(Limited procedures)

The auditor should perform the following procedures on required supplementary information:

1. Inquire of management about the methods used to prepare the required supplementary information, including whether it was prepared in accordance with prescribed guidance, whether there were changes in the methods used from prior years and reasons for those changes, and whether there were any significant assumptions underlying the measurement or presentation of the required information.
2. Determine if the supplementary information is consistent with management's responses, audited financial statements, and other knowledge.
3. Obtain written management representations regarding the required supplementary information.

If the auditor is unable to perform these procedures due to difficulties in dealing with management, the auditor should inform those charged with governance.

## C. Reporting on Supplementary Information

### 1. Opinion Not Required

Other-Matter Paragraph

An auditor is not required to audit required supplementary information. However, the audit report on the financial statements should include an *other-matter paragraph* with language to explain the following circumstances, as applicable:

a. the required supplementary information is included and the auditor has applied the required procedures;

b. the required supplementary information is omitted;

c. some required supplementary information is missing and some is presented in accordance with the prescribed guidelines;

d. the auditor has identified material departures from the prescribed guidelines;

e. the auditor is not able to complete the required procedures; or

f. there are unresolved doubts about conformance of required supplementary information.

Report deficiencies and omissions

This other-matter paragraph should include a disclaimer of opinion on the required supplementary information. If the auditor determines that the required information has not been presented as prescribed, and management refuses to make revisions, the auditor should describe the departure.

### 2. Opinion Permitted

An auditor may be engaged to report on whether required supplementary information is fairly stated, in all material respects, in relation to the financial statements as a whole. This engagement is performed as described above in Item II, "Reporting on Supplementary Information in Relation to the Financial Statements as a Whole."

## IV. REPORTS ON APPLICATION OF THE REQUIREMENTS OF AN APPLICABLE FINANCIAL REPORTING FRAMEWORK

Application of GAAP

### A. Reporting Accountant

1. A reporting accountant is an accountant in public practice, other than the continuing accountant, who prepares a written report (or provides oral advice) on:
   a. the application of the requirements of an applicable financial reporting framework to a specific transaction; or
   b. the type of report that may be rendered on a specific entity's financial statements.
2. The reporting accountant may not report on the application of accounting principles to a hypothetical transaction (a transaction not involving facts or circumstances of a specific entity).
3. The reporting accountant is not required to be independent of the entity.

### B. Procedures for Reporting Accountant

The reporting accountant should:

1. obtain an understanding of the form and substance of the specific transaction(s) or the conditions relevant to the type of report that may be issued on a specific entity's financial statements;
2. review the relevant requirements of the applicable financial reporting framework; and
3. if appropriate, consult with other professionals, experts or regulatory authorities, or perform additional research.

### C. Reporting Accountant and Continuing Accountant

The reporting accountant should request permission from the entity's management to consult with the continuing accountant, and should then consult with the continuing accountant to ascertain all the available facts relevant to forming a professional judgment. If the reporting accountant determines that it is not necessary to consult with the continuing accountant, the reporting accounting should document the rationale for not consulting.

### D. Reporting Accountant's Report

The accountant's report should be addressed to the requesting party and should include:

1. A brief description of the nature of the engagement.
2. A statement that the engagement was performed in accordance with AICPA standards.
3. An identification of the specific entity, a description of the specific transaction(s), a statement of the relevant facts, circumstances, and assumptions, and a statement about the source of the information.
4. A statement describing the appropriate application of the requirements of the applicable financial reporting framework (including the country of origin) to the specific transaction or type of report, and if appropriate, a description of the reasons for the reporting accountant's conclusion.

Mgt. is responsible

5. A statement that the preparers of the financial statements, who should consult with their continuing accountants, are responsible for proper accounting treatment.
6. A statement that any difference in the facts, circumstances, or assumptions presented may change the report.
7. A separate paragraph at the end of the report restricting its use to specified parties.
8. If the reporting accountant is not independent, a statement indicating the lack of independence.

Restrict use to: mgt., B of D, and specific parties (prior and current auditors)

## V. REPORTING ON FINANCIAL STATEMENTS PREPARED IN ACCORDANCE WITH A FINANCIAL REPORTING FRAMEWORK GENERALLY ACCEPTED IN ANOTHER COUNTRY

An auditor practicing in the United States may be engaged to report on financial statements that have been prepared in accordance with a financial reporting framework generally accepted in another country that has not been adopted by a body designated by the AICPA to establish generally accepted accounting principles, when such audited financial statements are intended for use outside the United States.

**PASS KEY**

Note that the AICPA has designated the International Accounting Standards Board (IASB) as a body that establishes generally accepted accounting principles. Therefore, these rules are not applicable to engagements to report on financial statements prepared in accordance with IFRS. Under AICPA standards, engagements to report on financial statements prepared in accordance with IFRS are conducted in accordance with the same rules that govern engagements to report on financial statements prepared in accordance with U.S. GAAP.

### A. Engagement Acceptance

In an audit of financial statements prepared in accordance with a financial reporting framework generally accepted in another country, the auditor should obtain an understanding of:

1. the purpose for which the financial statements are prepared;
2. whether the financial reporting framework is a fair presentation framework;
3. the intended users of the financial statements; and
4. the steps taken by management to determine whether the applicable financial reporting framework is acceptable in the circumstances.

The auditor should also obtain an understanding of the applicable legal responsibilities involved if the auditor plans to use the form and content of the auditor's report of another country.

### B. Engagement Performance

When performing the audit, the auditor should comply with GAAS and should consider whether the application of GAAS requires special consideration in the circumstances of the engagement. If the terms of the engagement require the auditor to apply the auditing standards of the country or the ISAs, the auditor should obtain an understanding of and apply those standards, as well as GAAS, except for requirements related to the form and content of the auditor's report.

## C. Reporting—*Distribution Outside the United States*

For distribution only outside the U.S. (or with limited distribution to specific knowledgeable parties within the U.S.), the auditor may use either:

1. The report of the other country or the report set out in the ISAs, if applicable, provided that:
   a. the report would be issued by auditors in the other country in similar circumstances;
   b. the auditor has obtained sufficient appropriate audit evidence to support the statements in the report; and
   c. the auditor has complied with the reporting standards of that country and identified the other country in the report.
2. A U.S. form of report that reflects that the financial statements being reported on have been prepared in accordance with a financial reporting framework generally accepted in another country, including:
   a. all the elements required in a U.S. form report; and
   b. a statement that refers to the note in the financial statements that describes the basis of presentation of the financial statements, including the country of origin.

## D. Reporting—Distribution in the United States

If the financial statements are also intended for use in the United States, the auditor should report using a U.S. form report with an emphasis-of-matter paragraph that:

1. identifies the financial reporting framework;
2. refers to the note in the financial statements that describes the framework; and
3. indicates that the framework differs from accounting principles generally accepted in the United States of America.

## E. Sample Report—*U.S. Form Report on Financial Statements Prepared in Accordance With a Financial Reporting Framework Generally Accepted in Another Country That Are Intended for Use Only Outside the United States*

**INDEPENDENT AUDITOR'S REPORT**

[*Appropriate Addressee*]

We have audited the accompanying financial statements of ABC Company, which comprise the balance sheet as of December 31, 20X1, and the related statements of income, changes in stockholders' equity, and cash flows for the year then ended, and the related notes to the financial statements, **which, as described by Note X to the financial statements, have been prepared on the basis of [*specify the financial reporting framework generally accepted*] in [*name of country*]**.

***Management's Responsibility for the Financial Statements***

Management is responsible for the preparation and fair presentation of these financial statements in accordance with **[*specify the financial reporting framework generally accepted*] in [*name of country*]**; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement whether due to fraud or error.

***Auditor's Responsibility***

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with auditing standards generally accepted in the United States of America **(and in [*name of country*])**. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

***Opinion***

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of ABC Company as of December 31, 20X1, and the results of its operations and its cash flows for the year then ended in accordance with **[*specify the financial reporting framework generally accepted*]** in **[*name of country*]**.

[*Auditor's signature*]

[*Auditor's city and state*]

[*Date of the auditor's report*]

## F. Sample Report—*U.S. Form Report on Financial Statements Prepared in Accordance With a Financial Reporting Framework Generally Accepted in Another Country That Are Also Intended for Use in the United States*

**INDEPENDENT AUDITOR'S REPORT**

[*Appropriate Addressee*]

We have audited the accompanying financial statements of ABC Company, which comprise the balance sheet as of December 31, 20X1, and the related statements of income, changes in stockholders' equity, and cash flows for the year then ended, and the related notes to the financial statements, **which, as described by Note X to the financial statements, have been prepared on the basis of [*specify the financial reporting framework generally accepted*] in [*name of country*]**.

***Management's Responsibility for the Financial Statements***

Management is responsible for the preparation and fair presentation of these financial statements in accordance with **[*specify the financial reporting framework generally accepted*] in [*name of country*]**; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement whether due to fraud or error.

***Auditor's Responsibility***

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with auditing standards generally accepted in the United States of America (and in [*name of country*]). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

***Opinion***

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of ABC Company as of December 31, 20X1, and the results of its operations and its cash flows for the year then ended in accordance with [***specify the financial reporting framework generally accepted***] in [***name of country***].

***Emphasis-of-Matter***

**As discussed in Note X to the financial statements, the Company prepares its financial statements in accordance with [*specify the financial reporting framework generally accepted*] in [*name of country*], which differs from accounting principles generally accepted in the United States of America. Our opinion is not modified with respect to this matter.**

[*Auditor's signature*]

[*Auditor's city and state*]

[*Date of the auditor's report*]

# APPENDIX

## The PCAOB Auditor's Reporting Model

## I. AUDITOR'S STANDARD REPORT *(for issuers)*

The PCAOB has not adopted the nonissuer auditor's reporting model introduced earlier in this lecture. The PCAOB plans to issue a separate auditor's reporting model for issuers in the near future. Until that model is issued, the auditor's report for issuers who are not required to have an integrated audit will use the old three-paragraph standard report that includes the following elements:

### A. Title

"Independent" (auditor's report) must be included in the report title.

### B. Addressee

The report is generally addressed to the company, its stockholders and/or its board of directors. It generally is not addressed to management.

### C. Introductory Paragraph

The introductory paragraph contains the following:

1. A statement that the financial statements as identified in the report were audited.
2. A statement that the financial statements are the responsibility of management and that the auditor's responsibility is to express an opinion.

### D. Scope Paragraph

The scope paragraph contains the following:

1. A statement that the audit was conducted in accordance with the standards of the Public Company Accounting Oversight Board (United States).
2. A statement that the audit was planned and performed to obtain reasonable assurance that the financial statements are free from material misstatement.
3. Statements that the audit included examining evidence on a test basis; assessing the accounting principles used and significant estimates made by management; and evaluating the overall presentation.
4. A statement that the audit provides a reasonable basis for an opinion.

### E. Opinion Paragraph

The opinion paragraph of the report contains the following:

1. A statement referring to the financial statements specifically identified in the introductory paragraph.
2. An opinion as to the fair presentation of the financial statements.
3. A statement regarding conformity with United States generally accepted accounting principles.

### F. Firm Name, City, and State

The firm's name, either printed or signed, must appear in the report. The city and state (or country) from which the report was issued should also be identified.

### G. Report Date

The date of the audit report must be included in the report.

1. The report should be dated on or after the date on which appropriate audit evidence, sufficient to support the opinion, has been obtained. Sufficient appropriate audit evidence includes evidence that:
   a. audit documentation has been reviewed;
   b. financial statements have been prepared; and
   c. management has taken responsibility for the financial statements.
2. The report date shows the final date of the auditor's responsibility.
3. For comparative statements, the date appropriate for the most recent audit should be used.

## II. UNQUALIFIED OPINION

### A. Sample Report—*Unqualified Opinion* *(reporting on a single year)*

**Auditor's Standard Report**

INDEPENDENT AUDITOR'S REPORT

Heading

Intro

We have audited the accompanying balance sheet of ABC Company as of December 31, 20XX, and the related statements of income, retained earnings, and cash flows for the year then ended. These financial statements are the **responsibility** of the Company's management. Our **responsibility** is to express an opinion on these financial statements based on our audit.

Scope

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of ABC Company as of (at) December 31, 20XX, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

Sign

(Name)

(Date)

*Note:* The auditor's report for the integrated audit of an issuer is described in the A5 lecture.

# AUDITING 2

*Other Reports*

# NOTES

# OTHER ENGAGEMENTS, REPORTS, AND ACCOUNTING SERVICES

Client does not necessarily have to comply with GAAP

## I. SPECIAL CONSIDERATIONS

**Special Considerations**

The auditor must address special considerations in the application of U.S. GAAS to engagements other than the audit of a complete set of financial statements in accordance with a general purpose financial reporting framework such as U.S. GAAP or IFRS. Special considerations apply to the following four areas:

(i) Audits of financial statements prepared in accordance with special purpose frameworks. Cash or tax

(ii) Audits of single financial statements and specific elements, accounts, or items of a financial statement. Audit A/R or inventory only

(iii) Reporting on compliance with aspects of contractual agreements or regulatory requirements in connection with audited financial statements.

(iv) Engagements to report on summary financial statements.

### A. Audits of Financial Statements Prepared in Accordance with Special Purpose Frameworks

Financial statements are "a structured presentation of historical financial information, including related notes, intended to communicate an entity's economic resources and obligations at a point in time or the changes therein for a period of time in accordance with a financial reporting framework." Normally, this financial reporting framework would be a general purpose framework such as U.S. GAAP or IFRS, but special purpose frameworks can also be used.

#### 1. Special Purpose Frameworks

| Special Considerations |
|---|
| Special Purpose Frameworks |
| Audits of Single FS or Specific Elements |
| Compliance: Audited FS |
| Summary Financial Statements |

A special purpose framework is a financial reporting framework other than GAAP that is one of the following bases of accounting:

**a. Cash Basis**

A basis of accounting that the entity uses to record cash receipts and disbursements and modifications of the cash basis having substantial support, such as recording depreciation on fixed assets.

**b. Tax Basis**

A basis of accounting that the entity uses to file its income tax return for the period covered by the financial statements.

**c. Regulatory Basis**

A basis of accounting used to comply with the requirements or financial reporting provisions of a regulatory agency having jurisdiction over the reporting entity.

**PASS KEY**

Certain regulators require financial statements to be prepared in accordance with a financial reporting framework that is based on U.S. GAAP, but does not comply with all of the requirements of U.S. GAAP. Such frameworks are regulatory bases of accounting.

**PASS KEY**

In January 2013, SAS 127 added to the list of special purpose frameworks any other basis of accounting that uses a definite set of logical, reasonable criteria that is applied to all material items appearing in the financial statements.

d. **Contractual Basis**

A basis of accounting that the entity uses to comply with an agreement between the entity and one or more third parties other than the auditor.

OCBOA

**PASS KEY**

The cash, tax, and regulatory bases of accounting are commonly referred to as other comprehensive bases of accounting.

**U.S. AUDITING STANDARDS VS. INTERNATIONAL STANDARDS ON AUDITING**

ISAs define a special purpose framework as a financial reporting framework designed to meet the financial information needs of specific users. U.S. auditing standards are more specific and define a special purpose framework as one of the following: cash, tax, regulatory, and contractual bases of accounting.

2. **Additional Requirements for the Auditor**

When applying auditing standards to an audit of financial statements prepared in accordance with a special purpose framework, the auditor should:

a. Obtain an understanding of:

(1) The purpose for which the financial statements are prepared.

(2) The intended users.

(3) The steps taken by management to determine that the applicable financial reporting framework is acceptable in the circumstances.

b. Obtain the agreement of management that it acknowledges and understands its responsibility to include all informative disclosures that are appropriate for the special purpose framework, including:

(1) A description of the special purpose framework, including a summary of significant accounting policies and how the framework differs from GAAP.

(2) Informative disclosures similar to GAAP when the special purpose framework contains items that are the same as or similar to those in GAAP financial statements.

(3) A description of any significant interpretations of the contract on which the special purpose financial statements are based, when the financial statements are prepared in accordance with a contractual basis of accounting.

(4) Additional disclosures beyond those required by the framework, if needed to achieve fair presentation.

c. Obtain an understanding of any significant interpretations of the contract that management made in the preparation of the financial statements, when special purpose financial statements are prepared in accordance with a contractual basis of accounting.

3. **Auditor's Report on Special Purpose Financial Statements**

The following items are the significant differences between the standard auditor's report and a report on special purpose financial statements:

a. **Describe the Purpose of the Financial Statements**

When the financial statements are prepared in accordance with a regulatory, contractual, or other basis of accounting, the auditor's report should describe the purpose for which the financial statements were prepared or refer to a note that contains that information.

b. **Non-GAAP Titles**

Special purpose statements should be suitably titled. Examples include:

Do not use GAAP terms

(1) Balance sheet—*cash basis*

(2) Statement of assets and liabilities arising from cash transactions—*cash basis*

(3) Statement of assets, liabilities, and stockholders' equity—*income tax basis*

(4) Statement of revenue collected and expenses paid—*cash basis*

(5) Statement of revenue and expenses—*income tax basis*

(6) Statement of income—*regulatory basis*

(7) Statement of operations—*income tax basis*

| Special Considerations |
|---|
| Special Purpose Frameworks |
| Audits of Single FS or Specific Elements |
| Compliance: Audited FS |
| Summary Financial Statements |

c. **Management Responsibility Paragraph**

The explanation of management's responsibility for the financial statements should also make reference to its responsibility for determining that the applicable financial reporting framework is acceptable in the circumstances (when management has a choice of financial reporting frameworks).

d. **Emphasis-of-Matter Paragraph**

Except when the special purpose financial statements are prepared in accordance with a regulatory basis and are intended for general use, the auditor's report should include an emphasis-of-matter paragraph that:

(1) Indicates that the financial statements are prepared in accordance with the applicable special purpose framework.

Accounting is ...

(2) Refers to the note to the financial statements that describes that framework.

(3) States that the special purpose framework is a basis of accounting other than GAAP.

**Other-Matter Paragraph**

e. **Other-Matter Paragraph**

Except when the special purpose financial statements are prepared in accordance with a regulatory basis and are intended for general use, the auditor's report should include an other-matter paragraph that restricts the use of the auditor's report to those within the entity, the parties to the contract or agreement, or the regulatory agencies to which the entity is subject, when the special purpose financial statement are prepared in accordance with either:

Restrict use

(1) a contractual basis of accounting; or

(2) a regulatory basis of accounting.

**PASS KEY**

An other-matter paragraph that restricts the use of the auditor's report should also be used when special purpose financial statements are prepared in accordance with an other basis of accounting.

| EXAMPLE |
|---|
| "Our report is intended solely for the information and use of the board of directors and management of ABC Company and *[name of regulatory agency]* and is not intended to be and should not be used by anyone other than these specified parties." |

**f. Regulatory Basis Financial Statements Intended for General Use**

If the special purpose financial statements are prepared in accordance with a regulatory basis and intended for general use, the auditor should not include an emphasis-of-matter or other-matter paragraph. Instead, the auditor should express an opinion about whether the financial statements are:

(1) Fairly presented, in all material respects, in accordance with GAAP.

(2) Prepared in accordance with the special purpose framework.

| U.S. AUDITING STANDARDS VS. INTERNATIONAL STANDARDS ON AUDITING |
|---|
| ISAs do not include requirements related to regulatory basis financial statements intended for general use. |

**g. Auditor's Report Prescribed by Law or Regulation**

- Lack of consistency
- Going concern
- Uncertainty
- Other auditors
- Emphasis of matter

If the auditor is required by law or regulation to use a specific layout, form, or wording of the auditor's report, the auditor's report should refer to GAAS only if the auditor's report includes, at a minimum, each of the elements listed below. If the prescribed specific layout, form, or wording of the auditor's report is not acceptable or would cause the auditor to make a statement that the auditor has no basis to make, the auditor should reword the prescribed form of report or attach an appropriately worded separate report.

**4. Reports on Special Purpose Financial Statements**

A report on special purpose financial statements should, at a minimum, include each of the following elements:

a. A title.

b. An addressee.

c. An introductory paragraph that identifies the special purpose financial statements audited.

d. A description of the responsibility of management for the preparation and fair presentation of the special purpose financial statements.

e. A reference to management's responsibility for determining that the applicable financial reporting framework is acceptable in the circumstances (when management has a choice of frameworks in the preparation of the financial statements).

f. A description of the purpose for which the financial statements are prepared when the financial statements are prepared in accordance with a regulatory or contractual basis.

g. A description of the auditor's responsibility to express an opinion on the special purpose financial statements and the scope of the audit that includes:

(1) A reference to GAAS and, if applicable, the law or regulation.

(2) A description of an audit in accordance with those standards.

Fair on "that" basis

h. An opinion paragraph that contains an opinion on the special purpose financial statements and a reference to the special purpose framework used to prepare the financial statements.

i. If applicable, an opinion on whether the special purpose financial statements are presented fairly, in all material respects, in accordance with GAAP when the special purpose financial statements are prepared in accordance with a regulatory basis and intended for general use.

j. An emphasis-of-matter paragraph that indicates that the financial statements are prepared in accordance with a special purpose framework, when required.

k. An other-matter paragraph that restricts the use of the auditor's report when required.

l. The auditor's signature.

m. The auditor's city and state.

n. The date of the auditor's report.

**SPECIAL PURPOSE FRAMEWORKS—OVERVIEW OF REPORTING REQUIREMENTS**

| | *Cash Basis* | *Tax Basis* | *Regulatory Basis* | *Regulatory Basis (General Use)* | *Contractual Basis* |
|---|---|---|---|---|---|
| *Opinion(s)* | Single opinion on special purpose framework | Single opinion on special purpose framework | Single opinion on special purpose framework | Dual opinion on special purpose framework and generally accepted accounting principles | Single opinion on special purpose framework |
| *Description of purpose for which special purpose financial statements are prepared* | No | No | Yes | Yes | Yes |
| *Emphasis-of-matter paragraph alerting readers about the preparation in accordance with a special purpose framework* | Yes | Yes | Yes | No | Yes |
| *Other-matter paragraph restricting the use of the auditor's report* | No | No | Yes | No | Yes |

### 5. Sample Report—*Auditor's Report on a Complete Set of Financial Statements Prepared in Accordance With the Cash Basis of Accounting*

Circumstances include the following:

a. The financial statements have been prepared by management of the entity in accordance with the cash basis of accounting.

b. Management has a choice of financial reporting frameworks.

Non-GAAP terms

**INDEPENDENT AUDITOR'S REPORT**

*[Appropriate Addressee]*

We have audited the accompanying financial statements of ABC Partnership, which comprise **the statement of assets and liabilities arising from cash transactions** as of December 31, 20X1, and the **related statement of revenue collected and expenses paid** for the year then ended, and the related notes to the financial statements.

MR DIM

***Management's Responsibility for the Financial Statements***

Management is responsible for the preparation and fair presentation of these financial statements in accordance with **the cash basis of accounting described in Note X; this includes determining that the cash basis of accounting is an acceptable basis for the preparation of the financial statements in the circumstances**. Management is also responsible for the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

REPPORTS CRAME

***Auditor's Responsibility***

Our responsibility is to express an opinion on the financial statements based on our audit. We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the partnership's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the partnership's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

***Opinion***

In our opinion, the **financial statements** referred to above present fairly, in all material respects, **the assets and liabilities arising from cash transactions of ABC Partnership as of December 31, 20X1, and its revenues collected and expenses paid during the year then ended in accordance with the cash basis of accounting described in Note X.**

Unmodified opinion on "that" basis

***Basis of Accounting***

* **We draw attention to Note X of the financial statements, which describes the basis of accounting. The financial statements are prepared on the cash basis of accounting, which is a basis of accounting other than accounting principles generally accepted in the United States of America. Our opinion is not modified with respect to this matter.**

[*Auditor's signature*]

[*Auditor's city and state*]

[*Date of the auditor's report*]

### 6. Sample Report—*Auditor's Report on a Complete Set of Financial Statements Prepared in Accordance With a Regulatory Basis of Accounting*

Circumstances include the following:

a. The financial statements and auditor's report are intended for general use.

b. The financial statements have been prepared by management of the entity in accordance with financial reporting provisions established by a regulatory agency.

c. Based on the regulatory requirements, management does not have a choice of financial reporting frameworks.

d. The variances between the regulatory basis of accounting and accounting principles generally accepted in the United States of America (U.S. GAAP) are not reasonably determinable and are presumed to be material.

Non-GAAP terms

MR DIM

REPPORTS CRAME

**INDEPENDENT AUDITOR'S REPORT**

*[Appropriate Addressee]*

We have audited the accompanying financial statements of XYZ City, Any State, which comprise **cash and unencumbered cash for each fund as of December 31, 20X1, and the related statements of cash receipts and disbursements and disbursements-budget and actual for the year then ended,** and the related notes to the financial statements.

***Management's Responsibility for the Financial Statements***

Management is responsible for the preparation and fair presentation of these financial statements in accordance with **the financial reporting provisions of Section Y of Regulation Z of Any State**. Management is also responsible for the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

***Auditor's Responsibility***

Our responsibility is to express an opinion on the financial statements based on our audit. We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinions.

***Basis for Adverse Opinion on U.S. Generally Accepted Accounting Principles***

**As described in Note X of the financial statements, the financial statements are prepared by XYZ City on the basis of the financial reporting provisions of Section Y of Regulation Z of Any State, which is a basis of accounting other than accounting principles generally accepted in the United States of America, to meet the requirements of Any State.**

**The effects on the financial statements of the variances between the regulatory basis of accounting described in Note X and accounting principles generally accepted in the United States of America, although not reasonably determinable, are presumed to be material.**

(continued)

(continued)

***Adverse Opinion on Generally Accepted Accounting Principles***

GAAP = Adverse

**In our opinion, because of the significance of the matter discussed in the "Basis for Adverse Opinion on U.S. Generally Accepted Accounting Principles" paragraph, the financial statements referred to above do not present fairly, in accordance with accounting principles generally accepted in the United States of America, the financial position of each fund of XYZ City as of December 31, 20X1, or changes in financial position or cash flows thereof for the year then ended.**

***Opinion on Regulatory Basis of Accounting***

Reg. basis = Unmodified opinion

In our opinion, the **financial statements** referred to above present fairly, in all material respects, **the cash and unencumbered cash of each fund of XYZ City** as of December 31, 20X1, and their **respective cash receipts and disbursements, and budgetary results** for the year then ended in accordance with the **financial reporting provisions of Section Y of Regulation Z of Any State as described in Note X**.

[*Auditor's signature*]

[*Auditor's city and state*]

[*Date of the auditor's report*]

## B. Audits of Single Financial Statements and Specific Elements, Accounts, or Items of a Financial Statement

| Special Considerations |
|---|
| Special Purpose Frameworks |
| **Audits of Single FS or Specific Elements** |
| Compliance: Audited FS |
| Summary Financial Statements |

An auditor may be engaged to audit and express an opinion on a single financial statement or on a specific element, account or item of a financial statement. An audit of a single financial statement or of specific elements, accounts, or items of a financial statement may be performed as a separate engagement or in conjunction with an audit of an entity's complete set of financial statements.

### 1. Examples

#### a. Single Financial Statements

The following are examples of single financial statements, each of which would include the related notes:

(1) Balance sheet

(2) Statement of income or statement of operations

(3) Statement of retained earnings

(4) Statement of cash flows

(5) Statement of assets and liabilities

(6) Statement of changes in owners' equity

(7) Statement of revenues and expenses

(8) Statement of operations by product line

#### b. Specific Elements, Accounts, or Items of a Financial Statement

The following are examples of specific elements, accounts, or items of a financial statement, each of which would include the related notes:

(1) Accounts receivable, allowance for doubtful accounts receivable, inventory, or the recorded value of intangible assets.

(2) A schedule of disbursements regarding a lease property.

(3) A schedule of profit participation or employee bonuses.

2. **Acceptability of the Financial Reporting Framework**

When auditing a single financial statement or a specific element of a financial statement, the auditor should obtain an understanding of:

a. the purpose for which the single financial statement or specific element of a financial statement is prepared;

b. the intended users; and

c. the steps taken by management to determine that the applicable financial reporting framework is acceptable in the circumstances.

3. **Audit Procedures**

When auditing a single financial statement or a specific element of a financial statement, the auditor should perform procedures on any interrelated items as necessary. Examples of interrelated items include sales and receivables, inventory and payables, and fixed assets and depreciation.

| PASS KEY |
|---|
| When auditing both a single financial statement or a specific element and an entity's complete set of financial statements, the auditor can use audit evidence obtained during the audit of the complete set of financial statements in the audit of the single financial statement or specific element. |

a. **Audit of Stockholders' Equity**

When the specific element is, or is based on, stockholders' equity, the auditor should perform procedures necessary to express an opinion about financial position because of the interrelationship between stockholders' equity and the balance sheet accounts.

b. **Audit of Net Income**

When the specific element is, or is based on, net income or the equivalent, the auditor should perform procedures necessary to express an opinion about financial position and results of operations because of the interrelationship between net income and the balance sheet and income statement accounts.

| U.S. AUDITING STANDARDS VS. INTERNATIONAL STANDARDS ON AUDITING |
|---|
| ISAs do not include a requirement for the auditor to perform procedures on interrelated items. |

4. **Materiality**

a. **Audit of a Single Financial Statement**

When auditing a single financial statement, the auditor should determine materiality for the single financial statement rather than for the complete set of financial statements.

b. **Audit of a Specific Element**

When auditing a specific element, the auditor should determine materiality separately for each element, rather than for the aggregate of all elements or the complete set of financial statements. As a result, an audit of a specific element is usually more extensive than if the same information were being considered in an audit of the complete set of financial statements.

**U.S. AUDITING STANDARDS VS. INTERNATIONAL STANDARDS ON AUDITING**

ISAs do not address the determination of materiality when auditing a single financial statement or a specific element of a financial statement.

### 5. Reporting on a Complete Set of Financial Statements and a Single Financial Statement or a Specific Element of Those Financial Statements

When auditing a complete set of financial statements and a single financial statement or a specific element of a financial statement, the auditor should:

a. Issue a separate auditor's report and express a separate opinion for each engagement. The reports may be published together provided they are sufficiently differentiated and the report on the complete set of financial statements is unmodified.

"other matters" paragraph

b. Indicate in the report on a specific element the date of the auditor's report on the complete set of financial statements and the nature of the opinion expressed on those financial statements under an appropriate heading.

**U.S. AUDITING STANDARDS VS. INTERNATIONAL STANDARDS ON AUDITING**

ISAs require the auditor to express a separate opinion for each engagement when reporting on a single financial statement or a specific element in conjunction with an audit of the entity's complete set of financial statements, but ISAs do not require that the opinions be in separate reports.

### 6. Modified Opinion on the Complete Set of Financial Statements

#### a. Modified Opinion Relevant to the Audit of a Specific Element

If the auditor's modified opinion on the complete set of financial statements is relevant to the audit of a specific element of the financial statements, the auditor should:

(1) Express an adverse opinion on the specific element when the modified opinion on the complete set of financial statements is due to a material misstatement of the financial statements. GAAP issue

(2) Express a disclaimer of opinion on the specific element when the modified opinion on the complete set of financial statements is due to a scope limitation. GAAS issue

**U.S. AUDITING STANDARDS VS. INTERNATIONAL STANDARDS ON AUDITING**

ISAs do not specifically require an adverse opinion or a disclaimer of opinion in these circumstances.

**b. Piecemeal Opinion**

When the auditor expresses an adverse opinion or a disclaimer of opinion on the complete set of financial statements, an unmodified opinion on a specific element in the same auditor's report would contradict the adverse opinion or disclaimer of opinion and would be the same as expressing a piecemeal opinion. In this situation, when the auditor considers it appropriate to express an unmodified opinion on the specific element, the auditor should do so only if:

(1) the opinion on the specific element is not published with and does not accompany the auditor's report on the complete set of financial statements; and which have adverse/disclaimer

(2) the specific element does not constitute a major portion of the entity's complete set of financial statements or the specific element is not, or is not based on, stockholders' equity or net income.

(a) A single financial statement is considered to be a major portion of a complete set of financial statements. Therefore, an unmodified opinion should not be expressed on a single financial statement if the auditor has expressed an adverse opinion or a disclaimer of opinion on the complete set of financial statements.

**7. Emphasis-of-Matter or Other-Matter Paragraphs**

On whole F/S → Add to this report

If the auditor's report on the complete set of financial statements includes an emphasis-of-matter or other-matter paragraph that is relevant to the audit of the single financial statement or the specific element, the auditor should include a similar emphasis-of-matter or other-matter paragraph in the auditor's report on the single financial statement or specific element.

**8. Reporting on an Incomplete Presentation that is Otherwise in Accordance with GAAP**

An incomplete presentation that is otherwise in accordance with GAAP is a type of single financial statement. When the auditor reports on an incomplete presentation that is otherwise in accordance with GAAP, the auditor's report should include an *emphasis-of-matter paragraph* that:

a. states the purpose for which the presentation is prepared and refers to the note in the financial statements that describes the basis of the presentation; and

b. indicates that the presentation is not intended to be a complete presentation of the entity's assets, liabilities, revenues, or expenses.

| U.S. AUDITING STANDARDS VS. INTERNATIONAL STANDARDS ON AUDITING |
|---|
| ISAs do not address reporting on incomplete presentations that are otherwise in accordance with the applicable financial reporting framework. |

### 9. Sample Report—*Auditor's Report on a Single Financial Statement Prepared in Accordance with a General Purpose Framework*

Circumstances include the following:

a. Audit of a balance sheet prepared in accordance with accounting principles generally accepted in the United States of America.

MR
DIM

REPPORTS
CRAME

**INDEPENDENT AUDITOR'S REPORT**

*[Appropriate Addressee]*

Only

We have audited the accompanying **balance sheet** of ABC Company as of December 31, 20X1, and the **related** notes to the financial statement.

***Management's Responsibility for the Financial Statement***

Management is responsible for the preparation and fair presentation of this financial statement in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of the financial statement that is free from material misstatement, whether due to fraud or error.

***Auditor's Responsibility***

Our responsibility is to express an opinion on the financial statement based on our audit. We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statement is free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statement. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statement, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statement in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statement.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

***Opinion***

In our opinion, **the financial statement referred to above** presents fairly, in all material respects, the financial position of ABC Company as of December 31, 20X1 in accordance with accounting principles generally accepted in the United States of America.

[*Auditor's signature*]

[*Auditor's city and state*]

[*Date of the auditor's report*]

## 10. Sample Report—*Auditor's Report on a Specific Element, Account, or Item Prepared in Accordance with a General Purpose Framework*

Circumstances include the following:

a. Audit of a schedule of accounts receivable prepared in accordance with accounting principles generally accepted in the United States of America.

b. The audit was conducted in conjunction with an audit of the entity's complete set of financial statements. That opinion was not modified and the report did not include an emphasis-of-matter or other-matter paragraph.

MR DIM

REPPORTS CRAME

**INDEPENDENT AUDITOR'S REPORT**

*[Appropriate Addressee]*

We have audited the accompanying **schedule of accounts receivable** of ABC Company as of December 31, 20X1, and the **related** notes to the schedule.

***Management's Responsibility for the Schedule***

Management is responsible for the preparation and fair presentation of this schedule in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of the schedule that is free from material misstatement, whether due to fraud or error.

***Auditor's Responsibility***

Our responsibility is to express an opinion on the schedule based on our audit. We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the schedule is free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the schedule. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the schedule, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the schedule in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the schedule.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

***Opinion***

In our opinion, the **schedule referred to above** presents fairly, in all material respects, the accounts receivable of ABC Company as of December 31, 20X1 in accordance with accounting principles generally accepted in the United States of America.

***Other Matter***

*

We have **audited, in accordance with auditing standards generally accepted in the United States of America, the financial statements of ABC Company as of and for the year ended December 31, 20X1, and our report thereon, dated March 15, 20X2, expressed an unmodified opinion on those financial statements.**

[Auditor's signature]

[*Auditor's city and state*]

[*Date of the auditor's report*]

### 11. Sample Report—*Auditor's Report on an Incomplete Presentation that is Otherwise in Accordance with Generally Accepted Accounting Principles*

Circumstances include the following:

a. Audit of the historical summaries of gross income and direct operating expenses (a single financial statement) prepared in accordance with accounting principles generally accepted in the United States of America.

MR
DIM

REPPORTS

CRAME

*

**INDEPENDENT AUDITOR'S REPORT**

*[Appropriate Addressee]*

We have audited the accompanying **Historical Summaries of Gross Income and Direct Operating Expenses of ABC Apartments for each of the three years in the period ended December 31, 20X1**, and the **related** notes to the historical summaries.

***Management's Responsibility for the Financial Statements***

Management is responsible for the preparation and fair presentation of these historical summaries in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of the historical summaries that are free from material misstatement, whether due to fraud or error.

***Auditor's Responsibility***

Our responsibility is to express an opinion on the historical summaries based on our audit. We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the historical summaries are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the historical summaries. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the historical summaries, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the historical summaries in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the historical summaries.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

***Opinion***

In our opinion, the **historical summaries referred to above present fairly, in all material respects, the gross income and direct operating expenses described in Note X** of ABC Apartments for each of the three years in the period ended December 31, 20X1 in accordance with accounting principles generally accepted in the United States of America.

***Emphasis of Matter***

We draw attention to Note X to the historical summaries, which describes that the accompanying historical summaries were prepared for the purpose of complying with the rules and regulations of Regulator DEF (for inclusion in the filing of Form Z of ABC Company) and are not intended to be a complete presentation of the Company's revenues and expenses. Our opinion is not modified with respect to this matter.

[*Auditor's signature*]

[*Auditor's city and state*]

[*Date of the auditor's report*]

| Special Considerations |
|---|
| Special Purpose Frameworks |
| Audits of Single FS or Specific Elements |
| Compliance: Audited FS |
| Summary Financial Statements |

## C. Compliance with Aspects of Contractual Agreements or Regulatory Requirements Related to Audited Financial Statements

**Compliance Related to Audited FS**

Often an auditor is asked to issue a report on a client's compliance with contractual agreements or regulatory requirements in connection with a financial statement audit. The auditor must have audited the client's financial statements and may only issue negative assurance on compliance.

This engagement is neither a compliance audit nor an attestation engagement, both of which may also be performed in relation to an entity's compliance with contractual agreements or regulatory requirements.

### 1. Negative Assurance = We are "not" lawyers

#### a. No Identified Instances of Noncompliance

Audit req. & No adverse/disclaimer

Negative assurance, in the form of a statement that nothing came to the auditor's attention that caused the auditor to believe that the entity failed to comply with the specified aspects of the contractual agreement or regulatory requirement, may be given when:

(1) There are no identified instances of noncompliance,

(2) The auditor has expressed an unmodified opinion or qualified opinion on the financial statements, and

(3) The applicable covenants or regulatory requirements have been subjected to audit procedures as part of the financial statement audit.

#### b. Identified Instances of Noncompliance

(1) When the auditor identifies one or more instances of noncompliance, the report on compliance should describe the noncompliance.

(2) If an adverse opinion or a disclaimer of opinion is expressed on the financial statements, a report on compliance can only be issued when there are identified instances of noncompliance.

### 2. Report on Compliance

The report on compliance should be in writing and may either be a separate report or provided in one or more paragraphs in the auditor's report on the financial statements.

Option #1

#### a. Separate Report on Compliance

When the auditor issues a separate report on compliance, the report should include the following:

(1) A title that includes the word "independent."

(2) An appropriate addressee.

(3) A paragraph that states that the financial statements were audited in accordance with U.S. GAAS and the date of the auditor's report on the financial statements.

(4) If the auditor expressed a modified opinion, a description of the nature of the modification.

(5) A reference to the specific covenants or paragraphs of the contractual agreement or regulatory requirement.

Negative assurance

(6) When there are no identified instances of noncompliance, a statement that nothing came to the auditor's attention that caused the auditor to believe that the entity failed to comply with the specified aspects of the contractual agreement or regulatory requirements, insofar as they relate to accounting matters.

(7) When instances of noncompliance are identified, a description of the instances of noncompliance.

(a) When the entity has obtained a waiver for such noncompliance, the auditor may include a statement in the report on compliance that a waiver has been obtained.

(8) A statement that the report is provided in connection with the audit of the financial statements.

(9) A statement that the audit was not directed primarily toward obtaining knowledge regarding compliance, and accordingly, had the auditor performed additional procedures, other matters may have come to the auditor's attention regarding noncompliance with the specific covenants or paragraphs of the contractual agreement or regulatory requirement, insofar as they relate to accounting matters.

(10) A paragraph that includes a description and the source of the significant interpretations, if any, made by management relating to the provisions of the relevant contractual agreement or regulatory requirement.

(11) A paragraph that restricts the use of the report to management, those charged with governance, others within the organization, the regulatory agency, or other parties to the contract or agreement.

(12) Signature of the firm.

(13) City and state where the auditor practices.

(14) Date of the report, which should be the same as the date of the auditor's report.

Option #2

b. **Report on Compliance Included in Auditor's Report**

The report on compliance is included in the auditor's report in an *other-matter paragraph* that includes the following:

(1) A reference to the specific covenants or paragraphs of the contractual agreement or regulatory requirement.

Negative assurance

(2) When there are no identified instances of noncompliance, a statement that nothing came to the auditor's attention that caused the auditor to believe that the entity failed to comply with the specified aspects of the contractual agreement or regulatory requirements, insofar as they relate to accounting matters.

(3) When instances of noncompliance are identified, a description of the instances of noncompliance.

(a) When the entity has obtained a waiver for such noncompliance, the auditor may include a statement in the report on compliance that a waiver has been obtained.

(4) A statement that the communication is provided in connection with the audit of the financial statements.

(5) A statement that the audit was not directed primarily toward obtaining knowledge regarding compliance, and accordingly, had the auditor performed additional procedures, other matters may have come to the auditor's attention regarding noncompliance with the specific covenants or paragraphs of the contractual agreement or regulatory requirement, insofar as they relate to accounting matters

(6) A paragraph that includes a description and the source of the significant interpretations, if any, made by management relating to the provisions of the relevant contractual agreement or regulatory requirement

(7) A paragraph that restricts the use of the report to management, those charged with governance, others within the organization, the regulatory agency, or other parties to the contract or agreement.

**PASS KEY**

When the auditor's report on compliance is included in the auditor's report on the financial statements, the restriction on the use of the report applies to the entire audit report. If a separate report is issued, then only the report on compliance needs to be restricted as to use.

### 3. Sample Report—*Separate Report on Compliance*

**INDEPENDENT AUDITOR'S REPORT**

Audited F/S

We have audited, in accordance with auditing standards generally accepted in the United States of America, the financial statements of XYZ Company, which comprise the balance sheet as of December 31, 20X2, and the related statements of income, changes in stockholders' equity, and cash flows for the year then ended, and the related notes to the financial statements, and have issued our report thereon dated February 16, 20X3.

Negative assurance

In connection with our audit, nothing came to our attention that caused us to believe that XYZ Company failed to comply with the terms, covenants, provisions, or conditions of sections XX to YY inclusive, of the Indenture dated July 21, 20X0, with ABC Bank, insofar as they relate to accounting matters. However, our audit was not directed primarily toward obtaining knowledge of such noncompliance. Accordingly, had we performed additional procedures, other matters may have come to our attention regarding the Company's noncompliance with the above-referenced terms, covenants, provisions, or conditions of the Indenture, insofar as they relate to accounting matters.

Restricted use

This report is **intended solely** for the information and use of the boards of directors and management of XYZ Company and ABC Bank and is not intended to be and should not be used by anyone other than these specified parties.

[*Auditor's Signature*]

[*Auditor's city and state*]

[*Date of the auditor's report*]

## D. Engagements to Report on Summary Financial Statements

| Special Considerations |
|---|
| Special Purpose Frameworks |
| Audits of Single FS or Specific Elements |
| Compliance: Audited FS |
| Summary Financial Statements |

An auditor may be engaged to report on whether summary financial statements are consistent, in all material respects, with the audited financial statements from which they have been derived.

### 1. Engagement Acceptance

The auditor should not accept this engagement unless the auditor has also been engaged to audit the financial statements from which the summary financial statements are derived. Before accepting the engagement, the auditor should:

a. Determine whether the criteria applied by management in the preparation of the summary financial statements are acceptable, including determining that the applied criteria:

   (1) Are free from bias.

   (2) Permit reasonably consistent quantitative or qualitative measures so that the information in the summary financial statements agrees with or can be recalculated from the audited financial statements.

   (3) Are sufficiently complete so that the summary financial statements contain the necessary information and are at the appropriate level of aggregation so that they are not misleading.

   (4) Are relevant to the summary financial statements.

b. Obtain an agreement of management, in writing, that it acknowledges and understands its responsibilities for:

   (1) The preparation of the summary financial statements in accordance with the applied criteria.

   (2) Clearly describing in the summary financial statements where the audited financial statements are available and making the audited financial statements readily available to the intended users of the summary financial statements when the summary financial statements are not accompanied by the audited financial statements.

   (3) Providing the auditor with written representations in the form of a representation letter. ISAs do not contain this requirement.

   (4) Including the auditor's report on the summary financial statements in any document that contains the summary financial statements and indicates the auditor has reported on them.

c. Obtain an agreement with management, in writing, about the expected form and content of the report on the summary financial statements, including an agreement that there may be circumstances in which the report will differ in form and content.

## 2. Procedures

The following procedures, and any other procedures deemed necessary, should be performed by the auditor:

a. Evaluate whether the summary financial statements adequately disclose their summarized nature and identify the audited financial statements.

b. When the summary financial statements are not accompanied by the audited financial statements, evaluate:

   (1) Whether the summary financial statements describe where the audited financial statements are available; and

   (2) Whether the audited financial statements are readily available to the intended users of the summary financial statements.

      (a) Readily available means that a third-party user can obtain the audited financial statements without any further action by the entity. For example, financial statements available on an entity's website are readily available, but being available on request is not readily available.

c. Evaluate whether the applied criteria are adequately disclosed.

d. Determine whether the summary financial statements can be agreed to or recalculated from the audited financial statements.

e. Evaluate whether the summary financial statements are prepared in accordance with the applied criteria.

f. Evaluate whether the summary financial statements contain the necessary information and are at an appropriate level of aggregation.

**3. Form of Opinion**

The auditor may issue an unmodified opinion or an adverse opinion on the summary financial statements. A qualified opinion is not appropriate due to the summarized nature of these financial statements.

**a. Unmodified Opinion on the Summary Financial Statements**

When the auditor concludes that an unmodified opinion is appropriate, the opinion should state that the summary financial statements are consistent, in all material respects, with the audited financial statements from which they have been derived, in accordance with the applied criteria.

**b. Adverse Opinion on the Summary Financial Statements**

The auditor should express an adverse opinion on the summary financial statements if the summary financial statements are not consistent, in all material respects, with the audited financial statements and management does not make the necessary changes.

**c. Adverse Opinion or Disclaimer of Opinion on the Audited Financial Statements** = Withdraw

The auditor should withdraw from the engagement to report on the summary financial statements when the auditor's report on the financial statements contains an adverse opinion or a disclaimer of opinion. If withdrawal is not possible under applicable law or regulation, the auditor's report should:

(1) State that the auditor's report on the financial statements contains an adverse opinion or a disclaimer of opinion.

(2) Describe the basis for the adverse opinion or the disclaimer of opinion.

(3) State that it is inappropriate to express and the auditor does not express an opinion on the summary financial statements.

**4. Report on Summary Financial Statements**

The auditor's report on summary financial statements should include the following elements:

a. A title that includes the word independent.

b. An appropriate addressee.

c. An introductory paragraph that:

(1) Identifies the summary financial statements.

(2) Identifies the audited financial statements.

(3) Refers to the auditor's report on the audited financial statements, including the date of the report and the type of opinion expressed.

(a) If the auditor's report on the financial statements contains a qualified opinion, an emphasis-of-matter paragraph, or an other-matter paragraph, the report on the summary financial statements should describe the basis for the qualified opinion, emphasis-of-matter, and other-matter paragraph and the effect on the summary financial statements, if any.

(4) If the date of the report is after the date of the report on the audited financial statements, states that the summary financial statements and audited financial statements do not reflect events that occurred after the date of the audit report.

(5) Indicates that the summary financial statements do not include all required disclosures and are not a substitute for the audited financial statements.

d. A description of management's responsibility for the summary financial statements.

e. A statement that the auditor is responsible for expressing an opinion about whether the summary financial statements are consistent, in all material respects, with the audited financial statements based on the procedures required by U.S. GAAS, including:

(a) A description of the procedures.

(b) If the date of the auditor's report on the summary financial statements is later than the date of the auditor's report on the audited financial statements, a statement that the auditor did not perform any audit procedures regarding the audited financial statements after the date of the report on those financial statements.

f. A paragraph that expresses an opinion on the summary financial information.

g. The auditor's signature.

h. The auditor's city and state.

i. Date of the auditor's report.

(1) The date of the report should be no earlier than:

(a) the date on which the auditor has obtained sufficient appropriate evidence on which to base the opinion on the summary financial statements; and

(b) the date of the auditor's report on the audited financial statements.

(2) When the date of the report on the summary financial statements is later than the date of the auditor's report on the audited financial statements and the auditor becomes aware of subsequently discovered facts relevant to the audited financial statements, the auditor should not release the report on the summary financial statements until the auditor's consideration of the subsequently discovered facts has been completed.

5. **Sample Report—*Unmodified Opinion on Summary Financial Statements***

Circumstances include the following:

a. Criteria are developed by management for the preparation of the summary financial statements and are disclosed in Note X. The auditor has determined that the criteria are acceptable.

b. An unmodified opinion is expressed on the audited financial statements.

c. The auditor's report on the summary financial statements is dated later than the date of the auditor's report on the audited financial statements.

**INDEPENDENT AUDITOR'S REPORT**

*[Appropriate Addressee]*

The accompanying summary financial statements, which comprise the summary balance sheet as of December 31, 20X1, the summary income statement, summary statement of changes in stockholders' equity, and summary cash flow statement for the year then ended, and the related notes, are derived from the audited financial statements of ABC Company as of and for the year ended December 31, 20X1. We expressed an unmodified audit opinion on those audited financial statements in our report dated February 15, 20X2. The audited financial statements, and the summary financial statements derived therefrom, do not reflect the effects of events, if any, that occurred subsequent to the date of our report on the audited financial statements.

The summary financial statements do not contain all the disclosures required by *[describe financial reporting framework applied in the preparation of the financial statements of ABC Company].* Reading the summary financial statements, therefore, is not a substitute for reading the audited financial statements of ABC Company.

***Management's Responsibility for the Summary Financial Statements***

Management is responsible for the preparation of the summary financial statements on the basis described in Note X.

***Auditor's Responsibility***

Our responsibility is to express an opinion about whether the summary financial statements are consistent, in all material respects, with the audited financial statements based on our procedures, which were conducted in accordance with auditing standards generally accepted in the United States of America. The procedures consisted principally of comparing the summary financial statements with the related information in the audited financial statements from which the summary financial statements have been derived, and evaluating whether the summary financial statements are prepared in accordance with the basis described in Note X. We did not perform any audit procedures regarding the audited financial statements after the date of our report on those financial statements.

***Opinion***

In our opinion, the summary financial statements of ABC Company as of and for the year ended December 31, 20X1 referred to above are consistent, in all material respects, with the audited financial statements from which they have been derived, on the basis described in Note X.

[*Auditor's signature*]

[*Auditor's city and state*]

[*Date of the auditor's report*]

Unaudited/disclaimer

# COMPILATION AND REVIEW OF FINANCIAL STATEMENTS

## I. LEVELS OF SERVICE

CPAs can perform two levels of service with respect to unaudited financial statements of a nonissuer.

### A. Compilation = No assurance

In a *compilation* engagement, the objective is to present in the form of financial statements information that is the representation of management without undertaking to express any assurance on the financial statements. The CPA does not perform any audit or review procedures. Although a compilation is not an assurance engagement, it is an attest engagement.

### B. Review = Limited assurance

A CPA may express limited (negative) assurance on financial statements that have not been audited. The objective of a *review* engagement is to express limited assurance that there are no material modifications that should be made to the financial statements in order for the statements to be in conformity with the applicable financial reporting framework. A review is based on inquiry and analytical procedures performed by the CPA. A review is both an assurance engagement and an attest engagement.

### C. Performance of More than One Service

When an accountant performs more than one service (for example, a compilation and an audit), the accountant generally should issue the report that is appropriate for the highest level of service rendered.

## II. PROFESSIONAL STANDARDS

### A. Statements on Standards for Accounting and Review Services *(SSARS)*

SSARS

The Accounting and Review Services Committee of the AICPA is the authoritative body designated to issue pronouncements in connection with the unaudited financial statements of nonissuers. The pronouncements issued are known as "Statements on Standards for Accounting and Review Services," or "SSARS."

#### 1. SSARS

Private companies (nonpublic)

a. An accountant should:

(1) Have sufficient knowledge to identify applicable SSARS.

(2) Exercise professional judgment in applying SSARS.

(3) Be able to justify departures from SSARS.

b. Specific language is used within SSARS to clarify the accountant's level of responsibility. The terms "must"/"is required," "should," and "may"/"might"/"could" are defined as described previously under auditing standards.

**2. Other Guidance**

a. An accountant should also consider applicable interpretive publications (e.g., SSARS interpretations and appendices, AICPA Accounting and Audit Guides, AICPA Statements of Position). These are considered recommendations as opposed to standards.

b. Other compilation and review publications (e.g., AICPA Compilation and Review Alert, articles in professional journals) have no authoritative status but may be helpful to the accountant.

**B. SSARS Applicability**

1. SSARS provide standards with respect to compilations and reviews of financial statements.

**a. Submission**

*"Submission"* is defined as presenting financial statements to a client or third party that the accountant has prepared, either manually or through the use of computer software. *"Preparation"* implies that the accountant has created financial statements that would not otherwise exist. An accountant who submits unaudited financial statements of a nonissuer should comply with SSARS.

**b. Nonissuer** = Private/nonpublic companies

A nonissuer is an entity (i) whose securities are not registered with the SEC; (ii) who is not required to file reports with the SEC; and (iii) who has not filed a registration statement (that is still pending) with the SEC.

2. SSARS also apply to engagements in which the accountant is engaged to compile or issue a compilation report on specified elements, accounts, or items of a nonissuer's financial statements, or on pro forma financial information of a nonissuer.

a. The issuance of a report is not required if an accountant prepares such information, or assists in preparing it, unless they have been specifically engaged to compile such information.

b. The accountant should, however, consider whether it might be prudent to issue a compilation report to clarify that no assurance is being provided, even if a report is not required.

**C. SSARS Do Not Apply**

**1. Other Accounting Services**

SSARS do not apply to other accounting services provided by accountants, such as preparing one or a few adjusting or correcting entries, consulting on financial matters, preparing tax returns, rendering manual or automated bookkeeping or data processing services, and processing financial data for clients of other accounting firms.

a. Note that if the accountant prepares many adjusting or correcting entries, this could be considered preparation of financial statements, and SSARS would apply. The accountant must exercise judgment in making this determination.

**2. SAS Applies**

SSARS are not applicable to reviews of interim financial information of nonissuers whose annual financial statements are audited. Statements on Auditing Standards apply to these engagements (covered later).

**D. Financial Statement Association**

Accountants should not consent to the use of their name in connection with unaudited financial statements unless they have compiled or reviewed them or the financial statements are accompanied by an indication that the accountant has not compiled or reviewed them and assumes no responsibility for them.

## III. ELEMENTS OF COMPILATION AND REVIEW ENGAGEMENTS

Compilation and review engagements include the following five elements.

**A. Three-party Relationship**

Compilation and review engagements involve three parties: management (the responsible party), an accountant in the practice of public accounting, and the intended users of the financial statements or financial information:

**1. Management**

Management—and when appropriate, those charged with governance—are responsible for:

a. the identification of an applicable financial reporting framework and individual accounting policies when alternatives are provided by the financial reporting framework;

b. the preparation and fair presentation of the financial statements in accordance with that framework; and

c. the design, implementation, and maintenance of internal control.

The accountant cannot issue an unmodified compilation or review report when management is unwilling to accept these responsibilities. The accountant may make suggestions about the form or content of the financial statements, or may prepare them based on information that is the representation of management.

**2. Accountant in the Practice of Public Accounting**

The accountant should possess knowledge of the accounting principles and practices of the industry in which the entity operates that will enable the accountant to compile or review the financial statements. An accountant should not accept an engagement if preliminary understanding of the engagement circumstances indicates that ethical requirements regarding quality control cannot be satisfied. In some cases, this requirement can be satisfied through the use of experts. When an expert is used, the accountant must be satisfied that the expert has the required skills and knowledge and that the accountant has adequate involvement in the engagement and an understanding of the work for which the expert is used.

### 3. Intended Users

The intended users are the person(s) or class of persons who understand the limitations of the compilation or review engagement and the financial statements. Management and the intended users may be the same. Intended users may be from the same entity or from different entities. The accountant has no responsibility to identify the intended users.

## B. Financial Reporting Framework

A financial reporting framework is the financial accounting standards established by an authorized or recognized standards setting body. Examples of financial reporting frameworks include U.S. GAAP as established by the Financial Accounting Standards Board, the Governmental Accounting Standards Board, or the Federal Accounting Standards Advisory Board; IFRS issued by the International Accounting Standards Board; and OCBOA.

### 1. OCBOA

Financial statements prepared in accordance with an OCBOA are not considered appropriate in form unless the financial statements include:

a. A description of the OCBOA, including a summary of significant accounting policies and a description of the primary differences from GAAP.

b. Disclosures similar to those required by GAAP if the financial statements contain items that are similar to those included in financial statements prepared in accordance with GAAP.

## C. Financial Statements or Financial Information

The financial reporting framework determines what constitutes a complete set of financial statements. An accountant may be engaged to compile or review a complete set of financial statements or an individual financial statement. Financial statements may be for an annual period, or for a shorter or longer period.

## D. Sufficient Appropriate Evidence *(review only)*

The accountant has no responsibility to obtain evidence about the accuracy or completeness of the financial statements in a compilation engagement. When performing a review engagement, the accountant should perform procedures to accumulate evidence to provide a reasonable basis for obtaining limited assurance that there are no material modifications that should be made to the financial statements in order for the statements to be in conformity with the applicable financial reporting framework. The accountant should use professional judgment to determine the nature, timing and extent of review procedures, which are limited relative to audit procedures. Review evidence is generally obtained through inquiry and analytical procedures.

## E. Written Communication or Report

If an accountant performs a compilation, a report or written communication is required, unless the accountant withdraws from the engagement. If an accountant performs a review, a written review report is required.

## IV. MATERIALITY

The accountant's determination of materiality is based on professional judgment and is affected by the needs of the users of the financial statements. Misstatements should be considered material if, individually or in aggregate, they could be reasonably expected to influence the economic decisions made by financial statement users, Judgments about materiality are based on circumstances and are impacted by the size and/or nature of the misstatement.

No assurance

## V. COMPILATION OF FINANCIAL STATEMENTS *(nonissuers only)* Private/nonpublic co.

A compilation of financial statements is a service, the objective of which is to present in the form of financial statements information that is the representation of management without undertaking to express any assurance on the financial statements.

### A. Establishing an Understanding with the Client *(engagement letter is presumptively mandatory)*

The accountant should establish an understanding with management and, when appropriate, those charged with governance, regarding the services to be performed for the compilation engagement and should document the understanding in an engagement letter.

The understanding with management should include:

1. The objectives of the engagement.
2. Management's responsibilities.
3. The accountant's responsibilities.
4. The limitations of the engagement, including statements that:
   a. the engagement cannot be relied upon to disclose errors, fraud, or illegal acts; and
   b. the entity will be informed of any information indicating that fraud or an illegal act may have occurred.
5. A description of other accounting services, if any, to be performed.
6. When the financial statements are not expected to be used by a third party and the accountant does not expect to issue a compilation report, the engagement letter should contain an acknowledgment of management's representation and an agreement that the financial statements are not to be used by a third party. When applicable, the following matters should also be addressed:
   a. Material departures from the applicable financial reporting framework may exist, and the effects of those departures, if any, on the financial statements may not be disclosed.
   b. Substantially all disclosures (and statement of cash flows, if applicable) required by the applicable financial reporting framework may be omitted.
   c. Reference to supplementary information.

### 7. **Sample—*Compilation Engagement Letter*** *(financial statements may be used by third parties)*

[*Appropriate Salutation*]

This letter is to confirm our understanding of the terms and objectives of our engagement and the nature and limitations of the services we will provide.

We will perform the following services:

We will compile, from information you provide, the annual [*and interim, if applicable*] financial statements of XYZ Company as of December 31, 20XX, and issue an accountant's report thereon in accordance with Statements on Standards for Accounting and Review Services (SSARs) issued by the American Institute of Certified Public Accountants (AICPA).

The objective of a compilation is to assist you in presenting financial information in the form of financial statements. We will utilize information that is your representation without undertaking to obtain or provide any assurance that there are no material modifications that should be made to the financial statements in order for the statements to be in conformity with [*the applicable financial accounting framework (for example, accounting principles generally accepted in the United States of America)*].

You are responsible for:

a. The preparation and fair presentation of the financial statements in accordance with [*the applicable financial reporting framework (for example, accounting principles generally accepted in the United States of America)*].

b. Designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements.

c. Preventing and detecting fraud.

d. Identifying and ensuring that the entity complies with the laws and regulations applicable to its activities.

e. Making all financial records and related information available to us.

We are responsible for conducting the engagement in accordance with SSARSs issued by the AICPA.

A compilation differs significantly from a review or an audit of financial statements. A compilation does not contemplate performing inquiry, analytical procedures, or other procedures performed in a review. Additionally, a compilation does not contemplate obtaining an understanding of the entity's internal control; assessing fraud risk; tests of accounting records by obtaining sufficient appropriate audit evidence through inspection, observation, confirmation, the examination of source documents (for example, cancelled checks or bank images); or other procedures ordinarily performed in an audit. Accordingly, we will not express an opinion or provide any assurance regarding the financial statements being compiled.

Our engagement cannot be relied upon to disclose errors, fraud, or illegal acts that may exist. However, we will inform the appropriate level of management of any material errors, and of any evidence or information that comes to our attention during the performance of our compilation procedures, that fraud may have occurred. In addition, we will report to you any evidence or information that comes to our attention during the performance of our compilation procedures regarding illegal acts that may have occurred, unless they are clearly inconsequential.

*If, during the period covered by the engagement letter, the accountant's independence is or will be impaired, insert the following:*

*We are not independent with respect to XYZ Company. We will disclose that we are not independent in our compilation report.*

(continued)

(continued)

If, for any reason, we are unable to complete the compilation of your financial statements, we will not issue a report on such statements as a result of this engagement.

Our fees for these services . . . .

We will be pleased to discuss this letter with you at any time. If the foregoing is in accordance with your understanding, please sign the copy of this letter in the space provided and return it to us.

Sincerely yours,

____________________________

[*Signature of accountant*]

Acknowledged:

XYZ Company

____________________________

President

____________________________

Date

## B. Compilation Requirements

**Compilation**

The following performance requirements are applicable to a compilation.

### 1. Knowledge of Industry Accounting Principles and Practices

Accountants should possess adequate knowledge of the accounting principles and practices of the client's industry to enable them to compile financial statements in an appropriate form. This does not prevent accountants from accepting engagements in an industry in which the accountants have no previous experience. However, the accountants are responsible for gaining the required level of knowledge.

### 2. Understanding of Client's Business

An accountant performing a compilation is required to have a general understanding of the client's business and the accounting principles and practices used by the client, including:

S a. **S**taff qualifications.

T b. **T**ransaction types and frequency.

A c. **A**ccounting basis used to prepare the financial statements.

F d. **F**orm of the accounting records.

F e. **F**inancial statements' form and content.

Never associated with false, fraudulent or misleading F/S

### 3. Reading the Financial Statements

Before issuing a report, accountants should read the compiled financial statements and consider whether they are appropriate in form and free from obvious material errors. The term error refers to arithmetical and clerical mistakes, as well as to mistakes related to the applicable financial reporting framework.

4. **Fraud and Illegal Acts, Going Concern, and Subsequent Events**

If an accountant becomes aware that fraud or an illegal act may have occurred, that there is a going concern uncertainty, or that a subsequent event has occurred, he or she should request management to consider the effect on the financial statements, evaluate management conclusions, and consider the effect of the matter on the compilation report.

## C. Financial Statements that May be Inaccurate or Incomplete

No audit work

Accountants are not required to, but may, make inquiries or perform other procedures to verify, corroborate, or review the information supplied by the client. However, if they discover the information is incorrect, incomplete, or unsatisfactory, they should obtain additional or revised information from the client. If the client refuses to provide such information, the accountants should withdraw from the compilation engagement.

## D. Documentation in a Compilation Engagement

Documentation provides the support that the accountant complied with SSARS when performing the compilation engagement. Documentation should provide clear detail of the work performed. The form and content of the documentation depends on the engagement, the methodology and tools, and the accountant's professional judgment. Documentation should include:

1. The engagement letter.
2. Any significant findings or issues, including the following:
   a. Results of compilation procedures indicating that the financial statements could be materially misstated and the actions taken to address these findings.
   b. The resolution of questions and concerns raised during compilation procedures.
3. Oral or written communications with management regarding fraud or illegal acts that came to the accountant's attention.

## E. Reporting on a Compilation

Independence not required → no assurance
(disclose lack of independence in report)

1. **Overview**

The report is the method by which the accountant communicates the extent of the responsibility assumed for the financial statements. An accountant may not issue any reports on unaudited financial statements of a nonissuer, or may not submit such financial statements to the client or others, unless the accountant has complied with the standards for a compilation.

The accountant's report in a compilation engagement should include the following:

**a. Title**

An appropriate title, such as *"Accountant's Compilation Report"* or *"Independent Accountant's Compilation Report."*

**b. Addressee**

The report should be addressed as appropriate.

c. **Introductory Paragraph**

The introductory paragraph should:

(1) Identify the entity.

C

(2) State that the financial statements have been compiled.

(3) Identify the financial statements.

(4) Specify the date or period covered by the financial statements.

A R

(5) State that the accountant has not reviewed or audited the financial statements and does not express an opinion or provide any assurance about whether the financial statements are in accordance with the applicable financial reporting framework.

M R

d. **Management's Responsibility Paragraph**

This paragraph should state that management is responsible for the preparation and fair presentation of the financial statements in accordance with the applicable financial reporting framework, and for designing, implementing and maintaining internal control relevant to the preparation and fair presentation of the financial statements.

A R S O M

e. **Accountant's Responsibility Paragraph**

This paragraph should:

(1) state that the accountant's responsibility is to conduct the compilation in accordance with SSARS issued by the AICPA; and

(2) state that the objective of a compilation is to assist management in presenting financial information in the form of financial statements without undertaking to obtain or provide any assurance that there are no material modifications that should be made to the financial statements.

f. **Signature of Accountant**

g. **Date of the Accountant's Report**

This should be the date of the completion of the compilation.

2. **Additional Requirements**

a. Each page of the statements should be marked *"See Accountant's Compilation Report"* or *"See Independent Accountant's Compilation Report."*

b. SSARS does not require that the compilation report be printed on the accountant's letterhead.

c. At the accountant's discretion, a separate paragraph of the report may be used to emphasize any matter already disclosed in the financial statements, such as going concern issues or subsequent events.

### 3. Sample Report—*Standard Compilation Report*

**ACCOUNTANT'S COMPILATION REPORT**

C A R I have compiled the accompanying balance sheet of XYZ Company as of December 31, 20XX, and the related statements of income, retained earnings, and cash flows for the year then ended. I have not audited or reviewed the accompanying financial statements and, accordingly, do not express an opinion or provide any assurance about whether the financial statements are in accordance with [*the applicable financial reporting framework (for example, accounting principles generally accepted in the United States of America)*].

M R Management is responsible for the preparation and fair presentation of the financial statements in accordance with [*the applicable financial reporting framework*] and for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements.

A R S O M My responsibility is to conduct the compilation in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. The objective of a compilation is to assist management in presenting financial information in the form of financial statements without undertaking to obtain or provide any assurance that there are no material modifications that should be made to the financial statements.

[*Signature of accounting firm or accountant*]

[*Date*] No assurance

### 4. Prescribed Forms that Call for a Departure from the Applicable Financial Reporting Framework

If an accountant is asked to compile financial statements included in a prescribed form that calls for a departure from the applicable financial reporting framework, an alternative form of standard report is used. An additional paragraph is added stating that the financial statements are presented in accordance with requirements not consistent with the applicable financial reporting framework, and that the financial statements are not designed for those who are uninformed about the resulting differences.

### 5. Reporting on Financial Statements that Omit Substantially All Disclosures

#### a. Compilation with Omission of All Disclosures

If requested by the client, an accountant may compile financial statements that omit substantially all disclosures required by the applicable financial reporting framework (but are otherwise in conformity with the financial reporting framework). The accountant may compile these statements provided:

(1) The accountant's report clearly indicates the omission by including a fourth paragraph disclosing such omissions. This paragraph should state that if the disclosures were included, they might influence the user's conclusions, and should indicate that the financial statements are not designed for those who are uninformed about the omitted disclosures; and

(2) To the accountant's knowledge, the omission is not intended to mislead any person who might be expected to use such financial statements.

Never associated with false, fraudulent or misleading F/S

**EXAMPLE**

Jones Retailing, a nonpublic entity, has asked Winters, CPA, to compile financial statements that omit substantially all disclosures required by generally accepted accounting principles (but are otherwise in conformity with GAAP). Winters may compile such financial statements provided the omission is **not** undertaken to mislead the users of the financial statements and is properly disclosed in the accountant's report.

**PASS KEY**

Compiled financial statements that omit GAAP disclosures are acceptable if the:

- Financial statements are otherwise in conformity with GAAP.
- Reason for omission was not to deceive the user.
- Compilation report warns the user of missing disclosures.

"Restricted use" not required

### b. Example—*Compilation Report with Additional Paragraph when the Financial Statements Omit Substantially All Disclosures*

**ACCOUNTANT'S COMPILATION REPORT**

I have compiled the accompanying balance sheet of XYZ Company as of December 31, 20XX, and the related statements of income, retained earnings, and cash flows for the year then ended. I have not audited or reviewed the accompanying financial statements and, accordingly, do not express an opinion or provide any assurance about whether the financial statements are in accordance with [*the applicable financial reporting framework (for example, accounting principles generally accepted in the United States of America)*].

Management is responsible for the preparation and fair presentation of the financial statements in accordance with [*the applicable financial reporting framework*] and for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements.

My responsibility is to conduct the compilation in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. The objective of a compilation is to assist management in presenting financial information in the form of financial statements without undertaking to obtain or provide any assurance that there are no material modifications that should be made to the financial statements.

**Management has elected to omit substantially all the disclosures required by [*the applicable financial reporting framework*]. If the omitted disclosures were included in the financial statements, they might influence the user's conclusions about the company's financial position, results of operations, and cash flows. Accordingly, these financial statements are not designed for those who are not informed about such matters.**

[*Signature of accounting firm or accountant*]

[*Date*]

c. **Compilation with Limited Disclosure**

If the accountant concludes that limited disclosure is acceptable and if the financial statements include only limited notes, the notes should be labeled as follows:

(Not adverse opinion)

*"Selected Information—Substantially All Disclosures Required by* [the applicable financial reporting framework] *are Not Included."*

6. **Departures from the Applicable Financial Reporting Framework** Disclose or Withdraw

Departures from the applicable financial reporting framework should be disclosed in a separate paragraph of the report and should include disclosure of the effects of the departure on the financial statements (if known). If the accountant believes disclosure in the report would not be adequate to indicate the deficiencies in the financial statements, he or she should withdraw from the engagement and provide no further services with respect to those financial statements.

7. **Reporting when Not Independent—*Disclosure Required***

An accountant who is not independent with respect to an entity may compile financial statements for such an entity and issue a report. The last paragraph of the report should disclose this lack of independence. The accountant is permitted, but not required, to disclose the reason(s) for the independence impairment in the report. All reasons must be included in the disclosure.

8. **Compilations of Personal Financial Statements** SSARS not req. → if no "credit"

An accountant may submit to the client unaudited personal financial statements that omit certain disclosures required by the applicable financial reporting framework. The accountant will be exempt from complying with the requirements of SSARS if:

a. the client agrees and the accountant states in the report that the personal financial statements will not be used to obtain credit or for any purpose other than developing the financial plan; and

b. nothing comes to the accountant's attention indicating that the financial statements will be used to obtain credit.

F. **Exception to Reporting Requirement**

Plain paper report

An accountant who submits unaudited financial statements to the client that are not expected to be used by a third party may use an engagement letter rather than a compilation report.

1. **Financial Statements Reasonably Expected to be Used by Third Parties**

a. A compilation report is required.

b. Reporting requirements were discussed above.

2. **Financial Statements Not Expected to be Used by Third Parties**

a. A written communication is required. It may consist either of a compilation report or an engagement letter (preferably signed by management) discussing the services to be performed and the limitations on use of the financial statements.

b. When an engagement letter (and not a report) is issued, the accountant should include a reference on each page of the financial statements restricting their use.

Use engagement letter (not a report) & restrict use

### 3. Sample—*Compilation Engagement Letter* *(financial statements not intended for third-party use)*

[*Appropriate Salutation*]

This letter is to confirm our understanding of the terms and objectives of our engagement and the nature and limitations of the services we will provide.

We will perform the following services:

We will compile, from information you provide, the [*monthly, quarterly, or other frequency*] financial statements of XYZ Company for the year 20XX.

The objective of a compilation is to assist you in presenting financial information in the form of financial statements. We will utilize information that is your representation without undertaking to obtain or provide any assurance that there are no material modifications that should be made to the financial statements in order for the statements to be in conformity with [*the applicable financial accounting framework (for example, accounting principles generally accepted in the United States of America)*].

You are responsible for:

a. The preparation and fair presentation of the financial statements in accordance with [*the applicable financial reporting framework (for example, accounting principles generally accepted in the United States of America)*].

b. Designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements.

c. Preventing and detecting fraud.

d. Identifying and ensuring that the entity complies with the laws and regulations applicable to its activities.

e. Making all financial records and related information available to us.

We are responsible for conducting the engagement in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants.

A compilation differs significantly from a review or an audit of financial statements. A compilation does not contemplate performing inquiry, analytical procedures, or other procedures performed in a review. Additionally, a compilation does not contemplate obtaining an understanding of the entity's internal control; assessing fraud risk; tests of accounting records by obtaining sufficient appropriate audit evidence through inspection, observation, confirmation, the examination of source documents (for example, cancelled checks or bank images); or other procedures ordinarily performed in an audit. Therefore, a compilation does not provide a basis for expressing any level of assurance on the financial statements being compiled.

Our engagement cannot be relied upon to disclose errors, fraud, or illegal acts that may exist. However, we will inform the appropriate level of management of any material errors and of any evidence or information that comes to our attention during the performance of our compilation procedures that fraud may have occurred. In addition, we will report to you any evidence or information that comes to our attention during the performance of our compilation procedures, regarding illegal acts that may have occurred unless they are clearly inconsequential.

(continued)

(continued)

The financial statements will not be accompanied by a report and are for management's use only and are not to be used by a third party.

*If, during the period covered by the engagement letter, the accountant's independence is or will be impaired, insert the following:*

*We are not independent with respect to XYZ Company.*

Our fees for these services …

We will be pleased to discuss this letter with you at any time. If the foregoing is in accordance with your understanding, please sign the copy of this letter in the space provided and return it to us.

Sincerely yours,

____________________

[*Signature of accountant*]

Accepted and agreed to:

XYZ Company

____________________

Title

____________________

Date

Limited assurance

## VI. REVIEW OF FINANCIAL STATEMENTS

Private/nonpublic/nonissuer

A review is a higher level of service than a compilation because it results in an expression of limited assurance. The review report states that the accountant is not aware of any material modifications necessary for the statements to conform with the applicable financial reporting framework. Inquiry and analytical procedures provide the accountant with a reasonable basis for this conclusion. The accountant is not required to obtain an understanding of internal control or assess control risk.

### A. Review Procedures Should be Tailored

Review procedures should be tailored to the specific engagement. For example, if the accountant becomes aware of significant changes in operations, additional procedures would be considered. The following factors may affect the procedures performed:

1. The nature and materiality of financial statement items.
2. The likelihood of misstatement.
3. Knowledge from current and previous engagements.
4. Qualifications of the entity's accounting personnel.
5. The extent to which an item is affected by management's judgment.
6. Inadequacies in the entity's underlying financial data.

## B. Review Requirements

The performance requirements applicable to a review are: Same for public/issuer

- **U**nderstanding with client should be established
- **L**earn and/or obtain sufficient knowledge of the entity's business
- * **I**nquiries should be addressed to appropriate individuals
- * **A**nalytical procedures should be performed
- **R**eview—other procedures should be performed
- * **C**lient representation letter should be obtained from management
- **P**rofessional judgment should be used to evaluate results
- **A**ccountant (CPA) should communicate results

### 1. Understanding with the Client Should be Established *(engagement letter is presumptively mandatory)*

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| Understanding |
| Learn Client |
| Inquiries |
| Analytical |
| Review—Other |
| Client Rep. Letter |
| Prof. Judgment |
| Acct. Report |

In order to reduce the likelihood of misunderstanding, the accountant should establish an understanding with management and, when appropriate, those charged with governance regarding the services to be performed and should document the understanding in the form of an engagement letter. The understanding should include:

a. The objectives of the engagement.

b. Management's responsibilities.

c. The accountant's responsibilities.

d. The limitations of the engagement.

### 2. Sample—*Review Engagement Letter*

[*Appropriate Salutation*]

This letter is to confirm our understanding of the terms and objectives of our engagement and the nature and limitations of the services we will provide.

We will perform the following services:

We will review the financial statements of XYZ Company as of December 31, 20XX, and issue an accountant's report thereon in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants.

The objective of a review engagement is to obtain limited assurance that there are no material modifications that should be made to the financial statements in order for the statements to be in conformity with [*the applicable financial reporting framework (for example, accounting principles generally accepted in the United States of America)*].

(continued)

 

(continued)

You are responsible for:

a. The preparation and fair presentation of the financial statements in accordance with [*the applicable financial reporting framework (for example, accounting principles generally accepted in the United States of America)*].

b. Designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements.

c. Preventing and detecting fraud.

d. Identifying and ensuring that the entity complies with the laws and regulations applicable to its activities.

e. Making all financial records and related information available to us.

f. Providing us, at the conclusion of the engagement, with a letter that confirms certain representations made during the review.

We are responsible for conducting the engagement in accordance with SSARSs issued by the AICPA.

A review includes primarily applying analytical procedures to your financial data and making inquiries of company management. A review is substantially less in scope than an audit, the objective of which is the expression of an opinion regarding the financial statements as a whole. A review does not contemplate obtaining an understanding of the entity's internal control; assessing fraud risk; tests of accounting records by obtaining sufficient appropriate audit evidence through inspection, observation, confirmation, or the examination of source documents (for example, cancelled checks or bank images); or other procedures ordinarily performed in an audit. Accordingly, we will not express an opinion regarding the financial statements as a whole. Our engagement cannot be relied upon to disclose errors, fraud, or illegal acts that may exist. However, we will inform the appropriate level of management of any material errors, and of any evidence or information that comes to our attention during the performance of our review procedures, that fraud may have occurred. In addition, we will report to you any evidence or information that comes to our attention during the performance of our review procedures regarding illegal acts that may have occurred, unless they are clearly inconsequential.

If, for any reason, we are unable to complete our review of your financial statements, we will not issue a report on such statements as a result of this engagement.

Our fees for these services. . . .

We will be pleased to discuss this letter with you at any time. If the foregoing is in accordance with your understanding, please sign the copy of this letter in the space provided and return it to us.

Sincerely yours,

______________________

[*Signature of accountant*]

Acknowledged:

XYZ Company

______________________

President

______________________

Date

 

### 3. Learn and/or Obtain Sufficient Knowledge of the Entity's Business

#### a. Knowledge of Accounting Principles and Practices of the Industry

As in a compilation, the accountant must be familiar with the accounting principles common to the client's industry. Lack of experience in an industry does not preclude acceptance of an engagement, but the accountant is required to obtain appropriate knowledge.

#### b. Understanding of Client's Business

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| Understanding |
| Learn Client |
| Inquiries |
| Analytical |
| Review—Other |
| Client Rep. Letter |
| Prof. Judgment |
| Acct. Report |

The accountant should possess an understanding of the client's business and the accounting principles and practices used by the client. This would ordinarily involve an understanding of the client's organization, its operating characteristics, and the nature of its assets, liabilities, equity, revenues, and expenses.

#### c. Not Required

The accountant is not required to:

Not auditing

**(1) Test Internal Control** → Not done

An understanding of internal control is not required in a review.

**(2) Perform Audit Tests** → Not done

No testing or audit procedures are required in a review.

**(3) Assess Fraud Risk** → Not done

A fraud risk assessment is not required in a review, nor is the accountant required to perform procedures designed to detect material misstatement due to fraud or illegal acts.

If, however, an accountant becomes aware that fraud or an illegal act may have occurred, he or she should consider the effect of the matter on the review report, and should request management to consider the effect on the financial statements.

**(4) Communicate with the Predecessor Accountant** → Judgment

The successor accountant may decide (but is not required) to communicate with the predecessor accountant regarding acceptance of the engagement and matters of continuing accounting significance.

#### d. Designing Review Procedures

The accountant should design the analytical procedures to be performed and the inquiries of management based on:

(1) the accountant's understanding of the industry;

(2) the accountant's knowledge of the client; and

(3) the risk that the accountant may unknowingly fail to modify the accountant's review report on financial statements that are materially misstated.

The results of the accountant's inquiries and analytical procedures may modify the accountant's risk awareness.

### 4. Inquiries Should be Addressed to Appropriate Individuals

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| Understanding |
| Learn Client |
| Inquiries |
| Analytical |
| Review—Other |
| Client Rep. Letter |
| Prof. Judgment |
| Acct. Report |

Inside company; not outside

The accountant's inquiries within the client's organization should be directed to members of management with financial and accounting responsibilities, to assure that adequate responses are obtained. The accountant is generally not required to corroborate management's responses with other evidence. Inquiries should cover the following:

a. Accounting principles and practices used, and the method of applying them;

b. Procedures for recording, classifying, and summarizing transactions, and for accumulating information for disclosure in footnotes;

c. Whether the financial statements have been prepared in conformity with the applicable financial reporting framework;

d. Whether there have been changes in the entity's business activities or accounting principles and practices;

e. Matters as to which questions have arisen during the course of the review;

f. Material subsequent events;

g. Unusual or complex situations that may affect the financial statements;

h. Significant transactions near the end of the period;

i. The status of uncorrected misstatements from previous engagements;

j. Material fraud or suspected fraud;

k. Significant journal entries and adjustments;

l. Communications from regulatory agencies;

m. Actions authorized by the stockholders, board of directors, or other management groups; and

n. Other items, such as the existence of related party transactions, that have been discussed with management and would be considered for inclusion in the representation letter.

| PASS KEY |
|---|
| The inquiries are of internal personnel, not of external people or entities. The examiners frequently have incorrect responses stating, "Make **inquiries** of **outside**..." |

### 5. Analytical Procedures Should be Performed

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| Understanding |
| Learn Client |
| Inquiries |
| Analytical |
| Review—Other |
| Client Rep. Letter |
| Prof. Judgment |
| Acct. Report |

Analytical procedures involve developing an expectation (based on plausible relationships) and comparing recorded amounts or ratios based on recorded amounts to that expectation. While expectations are not as encompassing as those developed during an audit (and corroboration is not required), analytical procedures in a review should still be designed to detect relationships and individual items that appear to be unusual and may indicate material misstatement. These procedures consist of:

Ratios & comparisons

a. comparing the current financial statements with prior period financial statements, or current ratios with prior period ratios;

b. comparing actual financial statements with budgets or forecasts, if available;

c. comparing financial and relevant nonfinancial information;

d. comparing the entity's ratios and indicators with those of other entities in the industry; and

e. comparing relationships among elements in the financial statements within the period and with corresponding prior period relationships.

Looking for predictable patterns

Analytical procedures may be performed at the financial statement level or at the detailed account level. If the results of analytical procedures identify fluctuations or relationships that are inconsistent with other relevant information or that differ significantly from expected values, the accountant should investigate these differences by inquiring of management and performing other procedures as necessary.

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| Understanding |
| Learn Client |
| Inquiries |
| Analytical |
| Review—Other |
| Client Rep. Letter |
| Prof. Judgment |
| Acct. Report |

**6. Review—*Other Procedures***

During a review, the accountant should also:

a. Read the financial statements for conformity with the applicable financial reporting framework.

b. Obtain reports of other accountants who have been engaged to audit or review significant components of the reporting entity.

c. If appropriate, request management to consider the effects of any going concern uncertainties or any subsequent events. The auditor should then consider whether management's conclusions are reasonable and whether the client's accounting and disclosures are adequate.

d. If during the performance of review procedures the accountant becomes aware of information that is incorrect, incomplete, or otherwise unsatisfactory, the accountant should request that management consider the effect of these matters on the financial statements. The accountant should consider management's assessment of the matter and determine the effect, if any, on the accountant's review report.

Rep. letter required

**7. Client Representation Letter from Management Must be Obtained**

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| Understanding |
| Learn Client |
| Inquiries |
| Analytical |
| Review—Other |
| Client Rep. Letter |
| Prof. Judgment |
| Acct. Report |

The accountant is required to obtain a representation letter from management for all financial statements and periods covered by the review report, even if current management was not present during all such periods. The letter should be dated as of the date of the accountant's report. The letter should be addressed to the accountant and signed by the members of management responsible for and knowledgeable about the matters in the letter (generally the CEO and CFO). Management's failure to provide a representation letter results in an incomplete review (see below).

**a. Contents of Letter**

Dated

Completion of review procedures performed

Management's representations should include:

(1) Management's responsibility for the preparation and fair presentation of the financial statements and their belief that they are fairly stated.

(2) Management's acknowledgment of its responsibility for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements.

(3) Management's full and truthful responses to all inquiries.

(4) Representations about the completeness of information.

(5) Information concerning subsequent events.

(6) Acknowledgement of management's responsibility to prevent/detect fraud.

(7) Knowledge of any material fraud or suspected fraud.

(8) Additional representations related to matters specific to the entity's business and industry.

### 8. Sample—*Management Representation Letter*

[*Date*]

To [*the accountant*]

We are providing this letter in connection with your review of the [*identification of financial statements*] of [*name of entity*] as of [*dates*] and for the [*periods of review (for example, the years then ended)*] for the purpose of obtaining limited assurance that there were no material modifications that should be made to the financial statements in order for the statements to be in conformity with [*the applicable financial reporting framework (for example, accounting principles generally accepted in the United States of America)*]. We confirm that we are responsible for the fair presentation of the financial statements in accordance with [*the applicable financial accounting framework*] and the selection and application of the accounting policies.

Certain representations in this letter are described as being limited to matters that are material. Items are considered material, regardless of size, if they involve an omission or misstatement of accounting information that, in the light of surrounding circumstances, makes it probable that the judgment of a reasonable person using the information would be changed or influenced by the omission or misstatement.

We confirm, to the best of our knowledge and belief, [*as of (date of the accountant's review report)*] the following representations made to you during your review:

1. The financial statements referred to above are fairly presented in accordance with [*the applicable financial reporting framework (for example, accounting principles generally accepted in the United States of America)*].
2. We have made available to you:
    a. Financial records and related data.
    b. Minutes of the meetings of stockholders, directors, and committees of directors, or summaries of actions of recent meetings for which minutes have not yet been prepared.
3. No material transactions exist that have not been properly recorded in the accounting records underlying the financial statements.
4. We acknowledge our responsibility for the preparation and fair presentation of the financial statements in accordance with [*the applicable financial reporting framework (for example, accounting principles generally accepted in the United States of America)*].
5. We acknowledge our responsibility for designing, implementing and maintaining internal control relevant to the preparation and fair presentation of the financial statements.

(continued)

(continued)

6. We acknowledge our responsibility to prevent and detect fraud.
7. We have no knowledge of any fraud or suspected fraud affecting the entity involving management or others where the fraud could have a material effect on the financial statements, including any communications received from employees, former employees, or others.
8. The company has no plans or intentions that may materially affect the carrying value or classification of assets and liabilities.
9. No material losses exist (such as from obsolete inventory or purchases or sales commitments) that have not been properly accrued or disclosed in the financial statements.
10. None of the following exist:
    a. Violations or possible violations of laws or regulations whose effects should be considered for disclosure in the financial statements or as a basis for recording a loss contingency.
    b. Unasserted claims or assessments that our lawyer has advised us are probable of assertion and must be disclosed in accordance with Financial Accounting Standards Board (FASB) *Accounting Standards Codification (ASC) 450 Contingencies*.
    c. Other material liabilities or gain or loss contingencies that are required to be accrued or disclosed by FASB ASC 450.
11. The company has satisfactory title to all owned assets, and there are no liens or encumbrances on such assets nor has any asset been pledged as collateral, excepts as disclosed to you and reported in the financial statements.
12. We have complied with all aspects of contractual agreements that would have a material effect on the financial statements in the event of noncompliance.
13. The following have been properly recorded or disclosed in the financial statements:
    a. Related-party transactions, including sales, purchases, loans, transfers, leasing arrangements, and guarantees, and amounts receivable from or payable to related parties.
    b. Guarantees, whether written or oral, under which the company is contingently liable.
    c. Significant estimates and material concentrations known to management that are required to be disclosed in accordance with FASB ASC 275, *Risks and Uncertainties*. [*Significant estimates are estimates at the balance sheet date that could change materially within the next year. Concentrations refer to volumes of business, revenues, available sources of supply, or markets or geographic areas for which events could occur that would significantly disrupt normal finances within the next year.*]
14. We are in agreement with the adjusting journal entries you have recommended, and they have been posted to the company's accounts (if applicable).
15. To the best of our knowledge and belief, no events have occurred subsequent to the balance-sheet date and through the date of this letter that would require adjustment to or disclosure in the aforementioned financial statements.
16. We have responded fully and truthfully to all inquiries made to us by you during your review.

______________________________

[*Name of Chief Executive Officer and Title*]

______________________________

[*Name of Chief Financial Officer and Title*]

a. **Updating the Management Representation Letter**

(1) An accountant may request an updating representation letter whenever:

(a) A significant amount of time has passed between the procedures performed and the issuance of the report.

(b) There has been a material subsequent event between completion of the procedures and issuance of the report.

(c) A former client requests the accountant to reissue a prior period report.

(2) An updating letter should state:

(a) Whether any previous representations should be modified, and

(b) Whether any subsequent events requiring adjustment to or disclosure in the financial statements have occurred.

## 9. Professional Judgment to Evaluate Results

Understanding
Learn Client
Inquiries
Analytical
Review—Other
Client Rep. Letter
Prof. Judgment
Acct. Report

### a. Incomplete Review

Accountants must be able to perform whatever procedures they deem necessary, and if those procedures are not accomplished, the review is incomplete. A review that is incomplete will prevent the issuance of a review report.

In such a situation, the accountant should consider whether the circumstances also prevent issuing a compilation report.

### b. Form and Content of Documentation

Review engagement documentation provides support for the representation that the accountant performed the review in accordance with SSARS and for the conclusion that the accountant is not aware of any material modifications that should be made to the financial statements in order for them to be in conformity with the applicable financial reporting framework.

Documentation should be sufficient to provide a clear understanding of the work performed, including the nature, timing, and extent of review procedures performed, the review evidence obtained and its source, and the engagement conclusions.

(1) The form and content of documentation in a review should be designed to meet the needs of the particular engagement.

(2) Written documentation from other types of engagements may be used to support the review report.

(3) Oral explanations may be used to supplement or clarify documentation, but should not be the primary support for the report.

Not included
- Test of internal controls
- Audit test work

(4) Documentation should include:

(a) The engagement letter documenting the understanding with the client.

(b) Significant findings, actions taken, and the basis for conclusions reached.

 

(c) Matters about which the accountant has made inquiry and responses thereto.

(d) Analytical procedures performed, including expectations and how they were developed, results of comparison to recorded amounts, and procedures performed with respect to significant differences.

(e) Unusual matters and their disposition.

(f) Communications (oral or written) to management regarding fraud and illegal acts.

(g) The management representation letter.

**PASS KEY**

The examiners frequently have incorrect responses to questions that suggest that audit test work, including testing of internal controls, is to be performed.

## 10. Accountant (CPA) Communicates Results

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| Understanding |
| Learn Client |
| Inquiries |
| Analytical |
| Review—Other |
| Client Rep. Letter |
| Prof. Judgment |
| Acct. Report |

### a. Reporting on a Review

The accountant's report in a review engagement should include:

**(1) Title**

An appropriate title that includes the word *independent*, such as *"Independent Accountant's Review Report."*

**(2) Addressee**

The report should be addressed as appropriate.

**(3) Introductory Paragraph**

The introductory paragraph should:

- Identify the entity.
- State that the financial statements have been reviewed.
- Identify the financial statements.
- Specify the date or period covered by the financial statements.

A M I S A D

- Include a statement that a review includes primarily applying analytical procedures to management's financial data and making inquiries of company management.
- Include a statement that a review is substantially less in scope than an audit, the objective of which is the expression of an opinion regarding the financial statements as a whole, and that, accordingly, the accountant does not express such an opinion.

M R F I

**(4) Management's Responsibility Paragraph**

This paragraph should state that management is responsible for the preparation and fair presentation of the financial statements in accordance with the applicable financial reporting framework and for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements.

R S A L A

**(5) Accountant's Responsibility Paragraph**

This paragraph should:

- State that the accountant's responsibility is to conduct the review in accordance with SSARSs issued by the AICPA.
- State that those standards require the accountant to perform procedures to obtain limited assurance that there are no material modifications that should be made to the financial statements.
- State that the accountant believes that the results of the engagement procedures provide a reasonable basis for the report.

**(6) Engagement Results Paragraph**

This paragraph should state that the accountant is not aware of any material modifications that should be made to the financial statements in order for them to be in conformity with the applicable financial reporting framework, other than those modifications, if any, indicated in the report.

**(7) Signature of Accountant**

**(8) Date of the Accountant's Report**

This should be the date of the completion of the review.

**b. Miscellaneous**

(1) Each page of the statements should be marked, *"See Independent Accountant's Review Report."*

(2) Uncertainties (such as those involving going concern issues) and inconsistencies in the application of accounting principles do not require modification of the review report as long as the financial statements include adequate disclosure.

(3) At the accountant's discretion, a separate paragraph of the report may be used to discuss uncertainties or inconsistencies, or to emphasize any matter already disclosed in the financial statements, such as going concern issues, subsequent events, significant related party transactions, or changes in accounting principle.

c. **Sample Report—*Standard Review Report***

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**INDEPENDENT ACCOUNTANT'S REVIEW REPORT**

We have reviewed the accompanying balance sheet of XYZ Company as of December 31, 20XX, and the related statements of income, retained earnings, and cash flows for the year then ended. A review includes primarily applying analytical procedures to management's financial data and making inquiries of company management. A review is substantially less in scope than an audit, the objective of which is the expression of an opinion regarding the financial statements as a whole. Accordingly, we do not express such an opinion.

Management is responsible for the preparation and fair presentation of the financial statements in accordance with [*the applicable financial reporting framework (for example, accounting principles generally accepted in the United States of America)*] and for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements.

Our responsibility is to conduct the review in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. Those standards require us to perform procedures to obtain limited assurance that there are no material modifications that should be made to the financial statements. We believe that the results of our procedures provide a reasonable basis for our report.

Based on our review, **we are not aware of any material modifications** that should be made to the accompanying financial statements in order for them to be in conformity with [*the applicable financial reporting framework*].

[*Signature of accounting firm or accountant*]

[*Date*]

d. **Accountant's Independence** *(required)* → Limited assurance

An accountant must be independent of the client to issue a review report on the financial statements of such a client. Note that any direct ownership of a company, no matter how small, will impair independence.

## VII. REPORTING ON DEPARTURES FROM THE APPLICABLE FINANCIAL REPORTING FRAMEWORK

In a review or compilation engagement, an accountant may become aware of a material departure from the applicable financial reporting framework. The accountant should recommend that the financial statements be revised to conform with the framework. If the financial statements are not revised, the accountant must then consider whether to modify the report or to withdraw from the engagement.

### A. Report Modification

When the accountant believes modification of the report is appropriate, a separate paragraph disclosing the departure should be added to the end of the report. The effects of the departure on the financial statements, if known, should also be disclosed. In a review report, the engagement results (fourth) paragraph of the report would refer to the explanatory paragraph as follows:

*"Based on our review, with the exception of the matter(s) described in the following paragraph, I am not aware of any material modifications that should be made…"*

### B. Report Modification Not Adequate → Withdraw

Do not issue "adverse" or "except for" opinion

If the accountant believes that disclosure in the report would not be adequate to indicate the deficiencies in the financial statements, he or she should withdraw from the engagement and provide no further services.

**PASS KEY**

An opinion, even qualified or adverse, requires an audit. When an accountant performing a compilation or review becomes aware of a GAAP departure, the report would be modified or the accountant would withdraw. An opinion would not be expressed.

Did not audit

## VIII. REPORTING FRAUD AND ILLEGAL ACTS

In a review or compilation engagement, if an accountant becomes aware that fraud or an illegal act may have occurred, such matters should be communicated to an appropriate level of management. Management should be asked to consider the effect of the fraud or illegal act on the financial statements. The accountant should consider the impact of the matter on the compilation or review report. When the accountant believes that the financial statements are materially misstated, the accountant should obtain additional or revised information. If the entity will not provide additional or revised information, the accountant should withdraw from the engagement.

### A. Inconsequential Matters

Inconsequential matters need not be communicated.

### B. Documentation

Communication may be made in writing or orally, but oral communications should be documented.

### C. Other Options

The accountant should consider withdrawing or consulting legal counsel if fraud or illegal acts involve an owner of the business.

### D. Confidentiality

Obligations of confidentiality preclude disclosure outside the entity except in certain limited circumstances (e.g., legal/regulatory requirements, successor accountant, subpoena).

## IX. SUBSEQUENT DISCOVERY OF FACTS EXISTING AT THE DATE OF THE COMPILATION OR REVIEW REPORT *(discovered after the report is issued)*

Usually, an accountant has no obligation to make continuing inquiries after the date of the report. However, if an accountant becomes aware of material information that existed as of the date of his or her report that would have affected the report, and that persons are currently relying or are likely to rely on the financial statements covered by the report, the accountant should take appropriate action.

## A. Accountant Action

Upon discovering, after issuance of the report, information (confirmed by the accountant) that materially affects the report and other persons' reliance on it, the accountant should advise the client to immediately disclose the new information and its impact on the financial statements to persons currently relying or likely to rely on the financial statements. This may be accomplished by:

1. advising the client to issue revised financial statements (along with a new compilation or review report) describing the reasons for revision; or
2. advising the client to make the necessary disclosures and revisions to any imminent financial statements (accompanied by the accountant's report for a subsequent period); or
3. if the effect on the financial statements cannot be determined on a timely basis, providing notification that the financial statements and report should not be relied upon.

Regardless of which disclosure method above is used, the accountant must become satisfied that appropriate steps have been taken by the client.

## B. Client Refuses to Follow Procedures

If the client refuses to proceed as above, the accountant should notify the appropriate entity personnel, such as the manager (owner) or board of directors, of such refusal, and of the fact the accountant will take additional steps to prevent further reliance on the accountant's report and the financial statements.

### 1. Additional Steps to Prevent Further Reliance

a. Notify the client that the accountant's report must no longer be associated with the financial statements.

b. Notify, if applicable, any regulatory agencies having jurisdiction over the client that the accountant's report should no longer be relied on.

c. Notify persons known to be relying or likely to rely on the financial statements that the accountant's report should no longer be relied on.

### 2. Notification

Any notification to parties other than the client should be as precise and factual as possible, and should contain a description of the effect the discovered information would have had on the accountant's report on the financial statements.

If the client has refused to cooperate, and as a result the accountants were unable to conduct an adequate investigation of the information, the accountants' disclosure need only state that information has come to their attention and that, if the information is true, their report should no longer be relied on or be associated with the financial statements.

The accountants should use their professional judgment in the circumstances described above, and it may be advisable to consult legal counsel.

## X. SUPPLEMENTARY INFORMATION

When the financial statements are accompanied by supplementary information for analysis purpose, the accountant should indicate the degree of responsibility he or she is taking with respect to the information.

### A. Compilation Engagements

When the accountant has compiled both the basic financial statements and the supplementary information, the compilation report should refer to the supplementary information, or the accountant can issue a separate report. If a separate report is issued, the report should state that the supplementary information is presented only for the purpose of additional analysis, and that the content has been compiled from information that is the representation of management, without audit or review, and that the accountant does not express an opinion or provide any assurance on such data.

### B. Review Engagements

When the accountant has performed a review of the basic financial statements, an explanation should be included in the review report or in a separate report. The report should state that the review has been made for the purpose of expressing a conclusion that no material modifications should be made to the financial statements in order for them to be in conformity with the applicable financial reporting framework, and that the supplementary information is presented only for the purpose of additional analysis and:

1. has been subjected to the inquiry and analytical procedures applied in the review of the basic financial statements, and that the accountant is not aware of any material modifications that should be made to the data; or

2. has not been subjected to the inquiry and analytical procedures applied in the review of the basic financial statements, but were compiled from information that is the representation of management without audit or review, and the accountant does not express an opinion or any other form of assurance on the data.

## XI. RESTRICTED USE REPORTS

An accountant may decide to restrict the use of a compilation or review report to certain specified parties (e.g., when the subject matter of the report is based on criteria other than GAAP or an OCBOA). Since the accountant cannot control distribution of his or her report after issuance, the report itself should clearly state that it is intended to be used only by the identified parties.

## XII. CHANGE IN ENGAGEMENT

From audit → to compilation or to review

During the course of an engagement, a client may ask the accountant to change an audit to a compilation or review, or a review to a compilation.

### A. Considerations

Before agreeing to a change, an accountant should consider the:

1. reason for the request, especially if there are scope limitations;
2. effort required to complete the engagement; and
3. estimated additional cost to complete the engagement.

Change must be justified

If the accountant decides a change in the engagement is justified, he or she must comply with the standards for a compilation or review, and then issue an appropriate report. The report should not refer to the original engagement, any procedures performed as part of the engagement, or any scope limitation.

## B. Reasons for Change

### 1. Acceptable Reasons

An audit may be changed to a compilation or review, or a review may be changed to a compilation, due to a:

a. Change in client requirements.

b. Misunderstanding as to the nature of the service to be rendered.

### 2. Unacceptable Reasons

The following are not acceptable reasons for a change:

Consider withdrawing

a. The engagement would uncover errors or fraud.

b. The client is attempting to create misleading or deceptive financial statements.

### 3. Scope Limitations

The auditor must consider the implications of a scope restriction in deciding whether a change in engagement is reasonable. The following are generally considered unacceptable reasons for a change:

Consider withdrawing

a. The client refuses to allow correspondence with legal counsel.

b. The client refuses to provide a signed representation letter.

## C. Compilation / Review Report Not Permitted

An accountant is generally precluded from issuing a compilation report or a review report when:

1. The accountant has been engaged to audit the entity's financial statements and has been prohibited by the client from corresponding with the entity's legal counsel.

2. The accountant has been engaged to audit or review the entity's financial statements and the client does not provide the accountant with a signed representation letter.

# REPORTING ON COMPARATIVE FINANCIAL STATEMENTS

## I. PERIOD(S) IN QUESTION

### A. All Periods Compiled or Reviewed

Comparative FS

When the periods presented in comparative financial statements are either all compiled or all reviewed, a continuing accountant should update the report on the prior period and issue it as part of the current report.

Each year is a different level of service

### B. Current Period Reviewed and Prior Period Compiled *(service upgrade)*

When the continuing accountant performs a higher level of service in the current period, the report on the prior period(s) should be updated and issued as the last paragraph of the current period's report.

### C. Current Period Compiled and Prior Period Reviewed *(service downgrade)*

In the event that accountants have reviewed the prior period statements but compiled the current period statements, they can do one of the following:

1. Issue a compilation report and add a paragraph to the report on the current period statements. The added paragraph should describe the responsibility assumed for the prior period statements. This description should include the date of the original report and a statement that no review procedures were performed in connection with the review engagement after the date of the review report.

or

2. Reissue the prior period review report. The reissued review report may be:

   a. combined with the current period compilation report; or

   b. presented separately from the current period compilation report.

   If a combined report is used (item a. above), the report should state:

   > "No review procedures were performed in connection with the review engagement after the date of the review report."

## II. OTHER REQUIREMENTS

### A. Columnar Form

Financial statements that have not been audited, reviewed, or compiled should not be presented in columnar form with financial statements on which an accountant has reported.

### B. Omission of Required Disclosures

Compiled financial statements that omit substantially all of the disclosures required by GAAP are not comparable to financial statements including such disclosures. The accountant should not issue a report on comparative financial statements when statements for one or more, but not all, of the periods presented omit substantially all of the disclosures required by GAAP.

 

### C. Information Affecting Previous Reports

During the current engagement, an accountant may become aware of information that would have affected the report on the prior periods. In such a situation, a previous modification made to disclose a departure from GAAP (or another applicable financial reporting framework) may no longer be necessary, or a new modification to disclose a departure from GAAP (or another applicable financial reporting framework) may be required.

A separate paragraph should be added to the prior period report that states:

1. the date of the original report;
2. that the statements of the prior period have been changed, if applicable; and
3. the reason for the change in the original report.

## III. OTHER ACCOUNTANTS INVOLVED IN PRIOR PERIODS

### A. Predecessor Accountant's Compilation or Review Report Reissued Unchanged

Predecessor accountants are not required to reissue their report on prior periods. If the predecessor accountants decide to reissue their report, they should:

1. Decide if their report is still appropriate:
   a. considering the current presentation of statements for the prior period;
   b. based on subsequent events; and
   c. in light of required modifications that may be necessary in their report.
2. Perform the following procedures:

old CPA should

   a. read the statements and the report of the current period;
   b. compare the prior period statements with those issued previously and currently; and
   c. obtain a letter from the successor accountants stating that they are not aware of any relevant information that might have a material effect on the prior period statements.

If the predecessor accountants become aware of information that may affect the financial statements or their report, they should (i) perform the same procedures they would have performed during the previous engagement, and (ii) perform any additional procedures they deem necessary.

| PASS KEY |
|---|
| Whenever predecessor accountants are asked to reissue their prior report (audit, review or compilation), they should read the new financial statements and obtain a representation letter from the new accountant. |

### B. Predecessor's Report Not Reissued

#### 1. Successor's Responsibility

In the event a predecessor accountant's report is not reissued, the successor accountants should either:

a. make reference to the report of the predecessor accountants in the current report; or

b. perform that level of service themselves.

#### 2. Expanded Report

In making reference to the predecessor accountant's report (item 1.a. above), the successor accountants should expand the report by including an additional paragraph mentioning the following:

a. a statement that the prior periods were compiled or reviewed by other accountants (who are generally not named, unless the predecessor's and successor's practices are combined);

b. the date of their report;

c. a description of the standard form of disclaimer or limited assurance given in the prior report; and

d. a description of any modifications contained in the report.

### C. Restated Prior-period Financial Statements

1. The predecessor or successor accountant may report on changed prior-period financial statements, as restated.

2. Alternatively, the successor accountant may report only on the restatement adjustment, while indicating a predecessor accountant reported on the prior-period financial statements before restatement.

## IV. REPORTING WHEN ONE PERIOD IS AUDITED

When unaudited (i.e., compiled or reviewed) financial statements are presented in comparative form with audited financial statements, the unaudited financial statements should be clearly marked and the accountant should either:

A. reissue the prior period report; or

B. include an additional paragraph in the current report describing the responsibility assumed for the prior period's statements.

#### 1. Current Period Unaudited and Prior Period Audited *(downgrade in service)*

When the prior period has been audited, the accountant should issue the current period compilation or review report, and any additional paragraph should indicate:

a. that prior period statements were audited;

b. the date of the previous report(s);

c. the opinions expressed, and, if other than unmodified, the reasons for the modification; and

d. that no auditing procedures have been performed since the previous report date.

### 2. Current Period Audited and Prior Period Unaudited *(upgrade in service)*

When the current period statements are audited, the auditor should include an other-matter paragraph in the auditor's report that includes:

a. the service (review or compilation) performed in the prior period;

b. the date of the prior period report;

c. a description of any material modifications described in the report;

d. a statement that the service was less in scope than an audit and did not provide the basis for an opinion.

> *Note:* If unaudited financial statements are presented in comparative form with audited financial statements in documents filed with the SEC, such statements should be marked *"unaudited,"* but should not be referred to in the auditor's report.

# REVIEW OF INTERIM FINANCIAL INFORMATION

"Issuer"/public company

Interim Financial Information

## I. BACKGROUND

### A. Definition

Interim financial information may be condensed or in the form of complete financial statements, and may cover:

1. a period less than a full year; or
2. a twelve-month period ending on a date other than the entity's fiscal year end.

### B. Applicability—*Nonissuers* *(SAS)*

An auditor may conduct a review of the interim financial information of a nonissuer if:

1. the latest financial statements have been audited;
2. the auditor either has been engaged to audit the entity's current year financial statements, or audited the entity's latest annual financial statements and the appointment of another auditor to audit the current year financial statements is not effective before the beginning of the period covered by the review;
3. the same financial reporting framework is used for the interim financial statements as was used in the annual financial statements; and
4. the interim financial information is condensed information, it conforms with an appropriate financial reporting framework, it includes an explanatory note, and it accompanies the latest audited financial statements (or those statements are made readily available).
   a. The explanatory note should indicate that the information does not represent complete financial statements, and that it should be read in conjunction with the latest annual financial statements.

### C. Applicability—*Issuers* *(PCAOB)*

#### 1. Situations Requiring a Review of Interim Financial Information

a. Certain entities are required by the SEC to file quarterly reports. The SEC requires that an independent auditor review such quarterly information before the quarterly report is filed.

b. Many entities are required by the SEC to include selected quarterly financial data in their annual reports or in other SEC filings. A review of such quarterly information is also required.

c. An auditor performing an initial audit of financial statements that include selected quarterly data should also perform a review of that data as part of the overall audit.

#### 2. Written Report

Although auditing standards do not require a written report on a review of interim financial information, if a client states, in a document filed with a regulatory agency or issued to shareholders or third parties, that an auditor has reviewed the interim financial information included therein, the review report must also be included in that document.

a. For example, the SEC requires that a review report be filed along with the interim financial information if an entity states, in any filing, that an independent public auditor has reviewed the interim financial statements.

## II. PROCEDURES (Same as nonissuer/nonpublic company)

Auditing standards require the auditor to perform the following procedures, each of which will be covered in greater detail below.

- **U**nderstanding with client should be established
- **L**earn and/or obtain sufficient understanding of the entity, its environment, including internal control
- **I**nquiries should be addressed to appropriate individuals
- **A**nalytical procedures should be performed
- **R**eview—other procedures should be performed
- **C**lient representation letter should be obtained from management
- **P**rofessional judgment should be used to evaluate results
- **A**uditor (CPA) should communicate results

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| Understanding |
| Learn Client |
| Inquiries |
| Analytical |
| Review—Other |
| Client Rep. Letter |
| Prof. Judgment |
| Acct. Report |

## III. UNDERSTANDING WITH THE CLIENT SHOULD BE ESTABLISHED

### A. Preacceptance Procedures

Before accepting an engagement to review an entity's interim financial information, the auditor should:

1. Determine whether the financial reporting framework used to prepare the interim financial information is acceptable.
2. Obtain the agreement of management that it acknowledges and understands its responsibility for: F/S & internal control
   a. the preparation and fair presentation of the interim financial information;
   b. the design, implementation, and maintenance of internal control sufficient to provide a reasonable basis for the preparation and fair presentation of the interim financial information;
   c. providing the auditor with access to the information and persons needed to complete the review; and
   d. including the auditor's review report in any document containing interim financial information that indicates that the information has been reviewed by the entity's auditor.

### B. Engagement Letter

In order to reduce the likelihood of misunderstanding, the auditor should establish an understanding with the client regarding the services to be performed through the use of an engagement letter. The understanding should include:

#### 1. Objectives and Scope of the Engagement

The objective of a review of interim financial information is to determine whether material modifications are necessary for the information to be in conformity with the applicable financial reporting framework. Making inquiries and performing analytical procedures provide the support for this type of reporting.

**2. Management's Responsibilities** = F/S & I/C

Management's responsibilities with respect to interim financial information are analogous to its responsibilities for annual financial statements, as covered in Auditing 3.

**3. Auditor's Responsibilities** = Review report

Not SSARS

The auditor is responsible for conducting the review in accordance with appropriate standards (SAS or PCAOB standards). A review, which consists primarily of analytical procedures and inquiries, is substantially less in scope than an audit, and therefore no opinion should be expressed.

**4. Limitations of the Engagement**

A review does not provide a basis for expressing an opinion, does not provide the auditor with a basis for obtaining reasonable assurance that the auditor will become aware of the significant issues and findings that would be identified in an audit, and is not designed to provide assurance regarding internal control. Communication is required if significant deficiencies or material weaknesses in internal control are noted.

**5. Financial Reporting Framework**

The engagement letter should identify the applicable financial reporting framework for the preparation of the interim financial information.

## IV. LEARN AND/OR OBTAIN AN UNDERSTANDING OF THE ENTITY AND ITS ENVIRONMENT, INCLUDING ITS INTERNAL CONTROL

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| Understanding |
| Learn Client |
| Inquiries |
| Analytical |
| Review—Other |
| Client Rep. Letter |
| Prof. Judgment |
| Acct. Report |

### A. Purpose

The auditor needs to have an understanding of the entity and its environment, including its internal control in order to:

1. Determine what types of material misstatements may occur.
2. Evaluate the likelihood that such misstatements will occur.
3. Select appropriate inquiries and analytical procedures.

### B. Planning

During planning, the auditor should update this understanding by performing the following procedures.

1. Read the documentation of prior audits and reviews to identify matters that may affect the current period's interim financial information.
2. Read the most recent annual financial information and financial information from recent comparable prior interim periods.
3. Consider the results of any audit procedures performed on the entity's current year financial statements.
4. Inquire of management regarding changes in business activities or internal control.
5. Inquire of management about the identity of and transactions with related parties.

### C. Obtaining Knowledge

**1. Initial Review**

In an initial review of interim financial information, the auditor should make inquiries of the predecessor auditor and, if permitted, review the predecessor's documentation.

 

a. The successor auditor remains solely responsible for the review procedures performed and the conclusions reached.

2. **Continuing Client**

An auditor who has audited the most recent annual financial statements may already have sufficient knowledge of internal control as it relates to interim financial information.

a. If the auditor has not audited the most recent annual financial statements, he or she should perform procedures to obtain knowledge about the entity's internal control.

b. Internal control over interim financial information may differ from internal control over annual financial statements (e.g., greater use of estimates may require different accounting principles and practices).

3. **Scope Restriction**

Significant deficiencies in internal control may make it impracticable for the auditor to perform a review.

## V. INQUIRIES SHOULD BE ADDRESSED TO APPROPRIATE INDIVIDUALS

Understanding
Learn Client
Inquiries
Analytical
Review—Other
Client Rep. Letter
Prof. Judgment
Acct. Report

### A. Required Inquiries

Inquiries should be directed to members of management with responsibility for financial and accounting matters, and should include queries regarding the following items.

1. Whether the interim financial information has been prepared in conformity with the applicable financial reporting framework.
2. Unusual or complex situations affecting the interim financial information.
3. Significant transactions during the last several days of the interim period.
4. The status of uncorrected misstatements from previous audits/reviews.
5. Subsequent events.
6. Fraud, suspected fraud, or allegations of fraud.
7. Significant journal entries and adjustments.
8. Communications from regulatory agencies.
9. Significant deficiencies and material weaknesses in internal control.
10. Changes in related parties or significant new related party transactions.
11. Questionable matters noted during other review procedures.

Not required but use judgment

### B. Inquiry of Client's Lawyer

Inquiry of the entity's lawyer regarding litigation, claims, and assessments generally is not required, but may be appropriate in certain circumstances.

### C. Going Concern

While a review of interim financial information is not designed to provide information regarding an entity's ability (or lack thereof) to continue as a going concern, such information may come to the auditor's attention, or may have existed at the date of prior period financial statements. In such cases, the auditor should make appropriate inquiries and consider the adequacy of disclosure, but is not required to corroborate mitigating factors.

## VI. ANALYTICAL PROCEDURES SHOULD BE PERFORMED

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| Understanding |
| Learn Client |
| Inquiries |
| Analytical |
| Review—Other |
| Client Rep. Letter |
| Prof. Judgment |
| Acct. Report |

The auditor uses his or her understanding of the entity and its environment, including its internal control to develop appropriate analytical procedures, inquiries, and other procedures.

Analytical procedures are performed to provide a basis for inquiry about unusual items, and should include the following items.

Trends A. Comparisons over time of interim financial information:

1. Current interim financial information vs. immediately preceding interim period.
2. Current interim financial information vs. comparable period from prior year.

Ratios B. Consideration of plausible relationships among both financial and relevant nonfinancial information.

Budget vs. actual C. Comparison of recorded amounts (or related ratios) to the auditor's expectations.

1. Expectations generally will be less precise than those developed during an audit.

D. Comparison of disaggregated revenue data (e.g., revenue by month and by product line) for the current interim period with that of comparable prior periods.

May want to "benchmark" & compare to industry standard

## VII. REVIEW—*Other Procedures* = Read other "stuff"

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| Understanding |
| Learn Client |
| Inquiries |
| Analytical |
| Review—Other |
| Client Rep. Letter |
| Prof. Judgment |
| Acct. Report |

Other procedures may also be used to address significant accounting and disclosure matters relating to interim financial information. The auditor should:

A. Read minutes of stockholder meetings, directors' meetings, etc., making appropriate inquiries if minutes are unavailable.

B. Obtain reports from any component auditors engaged to review the interim financial information of subsidiaries, investees, etc., making appropriate inquiries if reports have not been issued.

C. Obtain evidence that the interim financial information agrees or reconciles with the accounting records, and inquire of management regarding the reliability of those accounting records.

D. Read the interim financial information for conformity with the applicable financial reporting framework.

E. Read other information in documents containing the interim financial information for material inconsistencies or material misstatements of fact.

F. Extend review procedures to resolve any outstanding questions regarding the interim financial information's conformity with the applicable financial reporting framework.

**G. Timing and Coordination**

1. Review procedures may be performed before or simultaneously with the entity's preparation of the interim financial information.
2. Certain audit procedures related to the annual financial statement audit may be performed concurrently with the review.

## VIII. CLIENT WRITTEN REPRESENTATION LETTER FROM MANAGEMENT SHOULD BE OBTAINED → Required

Understanding | Learn Client | Inquiries | Analytical | Review—Other | Client Rep. Letter | Prof. Judgment | Acct. Report

As is the case with an audit, the auditor should obtain written representations from management related to the financial information, the completeness of information, recognition, measurement, disclosure, and subsequent events (covered in Auditing 5). If management refuses to provide one or more requested written representations or the auditor has concerns about the reliability of the representations, the auditor should:

F/S

Add I/C

A. discuss the matter with management and those charged with governance;

B. reevaluate the integrity of management; and

C. consider whether to withdraw from the review engagement and, if applicable, withdraw as the entity's auditor.

## IX. PROFESSIONAL JUDGMENT TO EVALUATE RESULTS

Understanding | Learn Client | Inquiries | Analytical | Review—Other | Client Rep. Letter | Prof. Judgment | Acct. Report

### A. Misstatements

The auditor should accumulate misstatements identified during the review and should evaluate the misstatements individually and in the aggregate to determine whether material modification should be made to the financial information for it to be in accordance with the applicable financial reporting framework.

### B. Scope Limitations

If the auditor is unable to perform necessary procedures or management does not provide appropriate representations, no review report should be issued. The auditor should communicate such matters, as well as known material departures from the applicable financial reporting framework, to management, those charged with governance, etc.

## X. AUDITOR COMMUNICATES RESULTS

Understanding | Learn Client | Inquiries | Analytical | Review—Other | Client Rep. Letter | Prof. Judgment | Acct. Report

### A. Communications to Management

Problem ↓ Management ↓ - B of D - Audit committee ↓ Withdraw (get legal advice)

1. Prompt communication to management is required if the auditor believes:

   a. Material modifications should be made to the interim financial information for it to be in accordance with the applicable financial reporting framework.

   b. An issuer filed quarterly reports with the SEC (Form 10-Q or Form 10-QSB) prior to completion of the review.

   c. A nonissuer issued the interim financial information prior to completion of the review (in situations that required a review).

2. If management does not respond appropriately to such communications, the auditor should inform those charged with governance.

3. If those charged with governance do not respond appropriately, the auditor should consider resigning, and may wish to consult legal counsel.

### B. Required Communications with Those Charged with Governance

An auditor conducting a review of interim financial information is subject to communication requirements analogous to those required in an audit. Communications are required with respect to:

1. Fraud and illegal acts.

2. Significant deficiencies or material weaknesses in internal control.

Communications to those charged with governance should be made on a timely basis (for issuers, communications should be made before the entity files its interim financial information with a regulatory agency, or as soon as practicable).

## C. Review Report on Interim Financial Information

= Issuer/public company

### 1. Required Elements

Each page of the interim financial information should be clearly marked *"unaudited,"* and the auditor's report thereon should include the following:

a. a title that includes the word *"independent"*;

b. an addressee appropriate to the engagement,

c. an introductory paragraph that:

(1) identifies the entity;

(2) states that the interim financial information was reviewed;

(3) identifies the interim financial information; and

(4) specifies the date or period covered by each financial statement included in the interim financial information.

d. A section with the heading "Management's Responsibility for the Financial Statements" that states that the preparation and fair presentation of the interim financial information is the responsibility of the entity's management, including responsibility for the design, implementation, and maintenance of internal control.

MR
DIM

e. A section titled "Auditor's Responsibility" that includes statements that:

Not SSARS

(1) The auditor's responsibility is to conduct the review of interim financial information in accordance with auditing standards generally accepted in the United States of America applicable to reviews of interim financial information.

**PASS KEY**

For a review of an issuer's interim financial information, the review report should include a statement that the review was conducted in accordance with the standards of the PCAOB.

(2) A review of interim financial information consists principally of applying analytical procedures and making inquiries of persons responsible for financial and accounting matters.

(3) A review of interim financial information is substantially less in scope than an audit conducted in accordance with auditing standards generally accepted in the United States of America, the objective of which is the expression of an opinion regarding the financial information as a whole, and accordingly, no such opinion is expressed.

f. A concluding section with an appropriate heading that includes a statement about whether the auditor is aware of any material modifications that should be made for the interim financial information to be in accordance with the applicable financial reporting framework and that identifies the country of origin of those accounting principles (if applicable).

g. A signature (manual or printed) of the auditor's firm.

h. The city and state where the auditor practices.

i. The date of the review report, which is the date of completion of the review procedures.

## 2. Sample Report

**INDEPENDENT AUDITOR'S REVIEW REPORT**

[*Appropriate Addressee*]

***Report on the Financial Statements***

We have reviewed the accompanying [*describe the interim financial information or statements reviewed*] of ABC Company and subsidiaries as of **September 30**, 20X1, and for the **three-month and nine-month periods** then ended.

***Management's Responsibility***

MR
DIM

The Company's management is responsible for the preparation and fair presentation of the interim financial information in accordance with [*identify the applicable financial reporting framework; for example, accounting principles generally accepted in the United States of America*]; this responsibility includes the design, implementation, and maintenance of internal control sufficient to provide a reasonable basis for the preparation and fair presentation of interim financial information in accordance with the applicable financial reporting framework.

***Auditor's Responsibility***

Our responsibility is to conduct our review in accordance with auditing standards generally accepted in the United States of America (or "Public Company Accounting Oversight Board (United States)") applicable to reviews of interim financial information. A review of interim financial information consists principally of **applying analytical procedures and making inquiries of persons responsible for financial and accounting matters.** It is **substantially less in scope** than an audit conducted in accordance with auditing standards generally accepted in the United States (or "Public Company Accounting Oversight Board"), the objective of which is the expression of an opinion regarding the financial information. Accordingly, **we do not express such an opinion.**

***Conclusion***

Based on our review, **we are not aware of any material modifications** that should be made to the accompanying interim financial information for it to be in accordance with [*identify the applicable financial reporting framework; for example, accounting principles generally accepted in the United States of America*].

[*Auditor's Signature*]

[*Auditor's city and state*]

[*Date of the auditor's report*]

## 3. Departures from the Applicable Financial Reporting Framework

a. The auditor should modify the report if, during the review, the auditor becomes aware of a departure from the applicable framework, such as inadequate disclosure or changes in accounting principle that are not in conformity with the framework.

b. The modification should include a description of the departure and, if determinable, the effects of the departure.

c. If there is inadequate disclosure in the interim information, auditors should also modify the report to include the necessary information, if practicable.

d. The report is modified by adding a Basis for Modification paragraph (preceding the Conclusion), and by modifying the conclusion to read:

> *"Based on our review, with the exception of the matter described in the preceding paragraph(s), we are not aware of any material modifications..."*

e. If the auditor believes that modification of the review report is not sufficient to address the deficiencies, the auditor should withdraw from the engagement.

**4. Going Concern and Lack of Consistency**

Disclosure in F/S is OK
otherwise
Modify review report

No report modification if disclosed (permitted but not required)

The existence of substantial doubt about the entity's ability to continue as a going concern or a lack of consistency does not require a report modification as long as disclosure is adequate. However, the auditor may choose to include an emphasis-of-matter paragraph in the auditor's review report to discuss these issues.

## XI. OTHER USES OF INTERIM FINANCIAL INFORMATION

### A. Interim Financial Information Accompanying Audited Financial Statements

Normally, there is no need to refer to the review in the audit report because interim financial information is not a required part of the financial statements. However, modifications to the audit report are necessary in the following circumstances:

1. When interim financial information included in a note to the financial statements is not marked *"unaudited,"* the auditor would disclaim an opinion on the interim financial information.
2. When interim financial information accompanies the audited financial statements, the auditor should include an other-matter paragraph in the auditor's report when all of the following conditions exist:
   a. The interim financial information that has been reviewed is included in a document containing audited financial statements.
   b. The interim financial information accompanying the audited financial statements does not appear to be presented in accordance with the applicable financial reporting framework.
   c. The auditor's separate review report that refers to the departure from the applicable financial reporting framework is not presented with the interim financial information.
3. For issuers, quarterly information required by the SEC has not been reviewed, so a paragraph should be added to the auditor's report, indicating the auditor was unable to review such information.
4. For issuers, quarterly information required by the SEC is omitted, so a paragraph should be added to the auditor's report, indicating the company has not presented such information.

### B. Interim Financial Information Presented in a Registration Statement

The Securities Act of 1933 imposes certain responsibilities on an auditor who prepares a report that is used in connection with a registration statement.

1. If an auditor's review report on interim financial information is presented (or incorporated by reference) in a registration statement, a prospectus that includes a statement about the independent auditor's involvement should clarify that the report is not considered to be a "report" or "part" of the registration statement within this context.

Nonissuer
Private company

Issuer
Private company



| | COMPILATION ENGAGEMENT | REVIEW ENGAGEMENT | | | AUDIT ENGAGEMENT |
|---|---|---|---|---|---|
| | *SSARS* | *SSARS* | *SAS* | *PCAOB* | *SAS/PCAOB* |
| *Level of Assurance* | None | Limited | | | Fair as to GAAP |
| *Entities* | Nonissuers only | Nonissuers | Nonissuers: Interim FS | Issuers: Interim FS | Issuers or Nonissuers |
| *Knowledge Required* | Knowledge of accounting principles and practices of industry; general understanding of client's business | Same as compilation plus increased knowledge of client's business | | | Extensive knowledge of economy, industry, and client's business |
| *Inquiry and Analytical Procedures Required* | None unless information is questionable | Inquiries of internal personnel<br><br>Analytical procedures | | | Inquiries of external parties and internal personnel<br><br>Analytical procedures<br><br>Audit procedures |
| *GAAP Disclosure Omitted* | May omit most without restricting use<br>Warn with ending paragraph | All are required or modify review report | | | All required or "qualified/adverse" opinion |
| *GAAP Departures* | Disclosure required | Disclosure required | | | Modify report "qualified/adverse" opinion |
| *Independence* | Not required but disclosure is required | Required | | | Required |
| *Engagement Letter* | Presumptively mandatory; required if no report | Presumptively mandatory | | | Presumptively mandatory |
| *Representation Letter* | Not required | Required | | | Required |
| *Understanding of Internal Control* | Not required (no test work) | Not required (no test work) | Required | | Required |
| *Errors and Irregularities Detection* | Only obvious errors found when reading financial statements | Only errors discovered through inquiry and analytical procedures | | | Must be designed to provide reasonable assurance of detection of material misstatements |
| | | | | | |
| *FS Reported on (BS/IS/RE/CF)* | One or more financial statements allowed to be reported on | One or more financial statements allowed if scope of inquiry and analytical procedures has not been restricted | | | One or more financial statements allowed if scope of audit is not limited and all necessary procedures are applied |
| *Communication with Predecessor* | Not required | Not required | Required | | Required |
| *Subsequent Event Inquiries* | Not required | Required | | | Required |

## OPINION WRITING FORMAT SUMMARY—SPECIAL CONSIDERATIONS

| | *Special Purpose Frameworks* | *Single Financial Statement or Specific Element* | *Summary Financial Statements* |
|---|---|---|---|
| *Title* | Independent Auditor's Report | Independent Auditor's Report | Independent Auditor's Report |
| *Addressee* | As required by circumstances | As required by circumstances | As required by circumstances |
| *Intro Paragraph—Service* | Audited | Audited | Refer to auditor's report on FS |
| *Intro Paragraph—Financial Statements* | List Non-GAAP Financial Statement | List Single Financial Statement or Specific Element | Identify Summary FS and Audited FS |
| *Intro Paragraph—Period(s)* | Single or Comparative Periods | Single or Comparative Periods | Single or Comparative Periods |
| *Management **R**esponsibility Paragraph* | Financial Statements<br>Internal Controls | Financial Statements<br>Internal Controls | Summary Financial Statements |
| *Auditor's **R**esponsibility Paragraph* | **M**gt. **R**esp. **C**ontrol<br>**R**esp. **E**xpress **R**eason<br>**P**lan **A**cct.<br>**D**esign **P**erf. **M**gt.<br>**I**mpl. **O**btain **E**val.<br>**M**ain **R**isk<br>**T**est<br>**S**tate | **M** **R** **C**<br>**R** **E** **R**<br>**P** **A**<br>**D** **P** **M**<br>**I** **O** **E**<br>**M** **R**<br>**T**<br>**S** | Express opinion about whether summary FS are consistent, in all material respects, with audited FS<br>Description of procedures |
| *Opinion Paragraph* | Opinion—Present fairly in accordance with special purpose framework | Opinion—Present fairly in accordance with framework | Opinion—Summary FS consistent with audited FS |
| *Opinion Paragraph* | Opinion—Present fairly in accordance with GAAP (if regulatory basis for general use) | | |
| *Emphasis-of-Matter Paragraph* | Describe basis of accounting | Describe purpose of presentation (audit of incomplete presentation in accordance with GAAP) | |
| *Other-Matter Paragraph* | Alert the restricts use (when required) | Describe audit report (audit of specific element in conjunction with FS audit) | |
| *Auditor's Signature* | CPA firm (manual or printed) | CPA firm (manual or printed) | CPA firm (manual or printed) |
| *Auditor's Address* | City and state | City and state | City and state |
| *Report Date* | Sufficient appropriate evidence obtained | Sufficient appropriate evidence obtained | No earlier than date of auditor's report or date sufficient appropriate evidence obtained |

| ENGAGEMENT SUMMARY | | | | | |
|---|---|---|---|---|---|
| | NONISSUERS | | | ISSUERS | |
| | *Compilation* | *Review* | *Review* | *Review* | *No audit or review* |
| *Service* | Compiled | Review | Review | Review | Unaudited |
| *Worked on* | FS | FS | Financial information | FS | FS |
| *Period* | Any date | Any date | Interim only | Interim only | Any date |
| *Standards* | AICPA—SSARS | AICPA—SSARS | AICPA—SAS | PCAOB | PCAOB |
| *Procedures* | Knowledge of industry<br>Understand business<br>Read the FS | **U**nderstanding with client<br>**L**earn entity's business<br>**I**nquiry<br>**A**nalytical procedures<br>**R**eview—other procedures<br>**C**lient rep letter<br>**P**rofessional judgment<br>**A**cct. communicates results | **U**nderstanding with client<br>**L**earn entity's business<br>**I**nquiry<br>**A**nalytical procedures<br>**R**eview—other procedures<br>**C**lient rep letter<br>**P**rofessional judgment<br>**A**cct. communicates results | **U**nderstanding with client<br>**L**earn entity's business<br>**I**nquiry<br>**A**nalytical procedures<br>**R**eview—other procedures<br>**C**lient rep letter<br>**P**rofessional judgment<br>**A**cct. communicates results | None—however, CPA must read the financial statements for obvious errors |
| *Findings* | No assurance (disclaimer) | Limited assurance | Limited assurance | Limited assurance | No assurance (disclaimer) |

Withdraw if false fraudulent deceptive misleading

## LETTERS FOR UNDERWRITERS

Underwriters

Negative assurance

## I. COMFORT LETTER = (on unaudited interim F/S)

Comfort Letter

A comfort letter is a letter from the CPA to the named underwriter and/or certain other requesting parties (e.g., selling shareholder, sales agent, broker-dealer, financial intermediary, or buyer/seller) just before the registration of the client's securities. It covers the period from the date of the last auditors' report to the effective date of the registration.

A comfort letter does not update the opinion on previously issued financial statements.

### A. Due Diligence

The Securities Act of 1933 provides that underwriters, among others, could be held liable for material omissions or misstatements in a registration statement.

1. A "due diligence defense" may be used by the underwriter (i.e., an underwriter who performs a reasonable investigation will not be held liable).

2. Underwriters request comfort letters from accountants as a part of their process of reasonable investigation.

### B. Review Engagement Required

When a comfort letter is to be issued, the CPA is required to perform a review of interim financial information in accordance with auditing standards. If the auditor states in the comfort letter that he or she issued a review report on unaudited interim financial information, then the auditor is required to attach the review report to the comfort letter.

*Note:* Comfort letters are not required by or filed with the SEC, and they are not considered to be part of the registration statement within the meaning of the Securities Act of 1933.

### C. Attorney's Opinion or Representation Letter Required

To obtain a comfort letter, the requesting party must provide the auditor with an attorney's opinion or a representation letter, confirming that such party has a due diligence defense.

1. If a requesting party, other than the underwriter, requests a comfort letter but does not provide a legal opinion or representation letter, the comfort letter provided by the auditor should not provide negative assurance on the financial statements as a whole, or on any specified elements, accounts, or items thereof.

### D. Restricted Use

A comfort letter must include a statement that the letter is solely for the information of the addressees and to assist the underwriters in conducting and documenting their investigation of the affairs of the company in connection with the offering, and that it is not to be used, circulated, quoted, or otherwise referred to for any other purpose.

## II. POSITIVE ASSURANCE

Positive assurance is provided with respect to:

A. A CPA's independence.

B. Compliance as to form of the financial statements with the SEC Act, assuming the financial statements are audited.

1. If the financial statements are not audited, negative assurance on compliance as to form is given.

Next page

## III. NEGATIVE ASSURANCE

Negative assurance is provided with respect to:

A. Unaudited financial statements, unaudited condensed interim financial statements, and capsule financial information, assuming a review of such information has been performed.

1. If a review has not been performed, the procedures performed and findings obtained should be listed.

B. Changes in selected financial statement items during a period subsequent to the date and period of the latest financial statements included in the registration statement, assuming an audit or review has recently been performed.

C. Whether certain non-financial statement information included in the registration statement complies as to form in all material respects with regulation S-K.

1. In a comfort letter, no comment should be made regarding compliance of the Management's Discussion and Analysis (MD&A) with SEC rules and regulations.
2. However, accountants may agree to examine or review MD&A (covered later).

## IV. PROCEDURES PERFORMED AND FINDINGS OBTAINED

A list of procedures performed and findings obtained is provided with respect to:

A. Pro forma financial information and financial forecasts included in the registration statement.

1. Negative assurance on pro forma financial information may be provided if the auditor has an appropriate level of knowledge of the accounting and financial reporting practices of the entity and has performed:
    a. an audit of the annual financial statements; or
    b. a review of the interim financial information of the entity to which the pro forma adjustments were applied, in accordance with GAAS applicable to reviews of interim financial information.

B. Tables, statistics, and other financial information included in the registration statement, unless the information:

1. is expressed in dollars (or percentages derived from dollar amounts) and has been obtained from accounting records that are subject to internal control over financial reporting; or
2. has been derived directly from such accounting records by analysis or computation.

## V. WHEN THE AUDITOR SHOULD NOT COMMENT OR PROVIDE ASSURANCE

The auditor should not comment or provide assurance on:

Limitations

A. Market risk sensitive instruments

B. Qualitative disclosures

Auditing/examining something other than historical F/S

# ATTEST ENGAGEMENTS

## I. INTRODUCTION

Attest Engagements

Attestation services are a type of engagement gaining in importance. Attest engagements have grown out of the need for independent examination of an expression of assurance on subject matters other than basic financial statements.

### A. Definition

Attest engagements are defined as those in which a practitioner (CPA) is engaged to issue or does issue an examination, a review, a compilation, or an agreed-upon procedures report on subject matter, or on an assertion about the subject matter, that is the responsibility of another party (usually management). An attest engagement may be part of a larger engagement, such as a feasibility study or a business acquisition study.

1. Attest engagements may result in reports related to:

   a. Compliance with laws and regulations

   b. Compliance with contracts

   c. Internal control

   d. Computer systems and software (see Trust Services, below)

   e. Information supplemental to financial statements

   f. Prospective information

   g. Performance, physical characteristics, historical events, analyses, etc.

2. **Trust Services**

   Trust Services are assurance and advisory services used to address the risks and opportunities related to information technology. Five essential principles guide the performance of Trust Service engagements: security, availability, processing integrity, online privacy, and confidentiality.

   a. **WebTrust Engagements**

   WebTrust engagements provide assurance related to e-commerce. The CPA assesses a client's web site for predefined criteria that are designed to measure transaction integrity, information protection, and disclosure of business practices.

   b. **SysTrust Engagements**

   SysTrust engagements provide assurance with respect to the reliability of any defined electronic system.

## B. Statements on Standards for Attestation Engagements (SSAE)

Statements on Standards for Attestation Engagements (SSAE) established by the AICPA provide information addressing the major attestation services:

1. Agreed-upon procedures (excluding letters to underwriters and consulting services under SSCS and with specific prohibition of any attest engagement concerning assertions of solvency or insolvency).
2. Financial forecasts and projections.
3. Pro forma financial statements.
4. Internal control over financial reporting.
5. Compliance (as a specific engagement, not as part of an audit for which a special report is issued, and not as an engagement performed under Government Auditing Standards).
6. Management's discussion and analysis. Required by SEC

Each type of attestation service allows a different combination of reporting options:

| | REPORT TYPE | | | |
|---|---|---|---|---|
| *Attestation Service* | *Examination* | *Review* | *Compilation* | *Agreed-Upon Procedures* |
| Agreed-upon procedures | | | | ✓ |
| Prospective financial statements | ✓ | | ✓ | ✓ |
| Pro forma financial statements | ✓ | ✓ | | |
| Internal controls | ✓ | | | ✓ |
| Compliance | ✓ | | | ✓ |
| MD&A | ✓ | ✓ | | |

**PASS KEY**

The following standards apply to services a CPA may provide:

- Audit engagements: SAS (Statements on Auditing Standards); PCAOB standards for issuers
- Compilation and review engagements: SSARS (Statements on Standards for Accounting and Review Services)
- Attest engagements: SSAE (Statements on Standards for Attestation Engagements)

## C. Statements on Standards for Attestation Engagements Do Not Apply to:

1. Audits.
2. Compilations and reviews of the financial statements of nonissuers under SSARS.
3. Return preparation (income tax, franchise, other).
4. Advocating for the client (litigation services).
5. Providing consulting/advisory services.
6. Operational audits, which are normally performed by internal auditors to evaluate the effectiveness and efficiency of various components or processes of a company.

## D. Attestation Standards

A framework for attest function beyond historical financial statements

Attestation Standards

1. Attestation standards are intended to provide guidance and set boundaries around the increasingly broad variety of attestation services rendered by a CPA (also referred to as a practitioner). They are issued by senior technical bodies of the AICPA. Attestation standards provide a measure of quality and describe the objectives to be achieved in an attestation engagement.

2. Attestation standards are much broader in scope than GAAS and apply specifically to attestation engagements. They do not supersede any existing standards (SAS, SSARS) for other engagements.

3. Attestation standards are a natural extension of GAAS but differ conceptually from GAAS in three ways:

   a. no reference is made to financial statements;

   b. no reference is made to generally accepted accounting principles; and

   c. attestation standards provide levels of assurance below that provided by a GAAS audit.

   In addition, attestation standards provide for services tailored to the needs of the user, who may directly participate in specifying either the nature and scope of the engagement or the criteria against which the assertions are measured. (In such engagements, a limited use report is provided.)

4. Attestation standards include a hierarchy similar to the GAAS hierarchy covered previously:

   a. Departures from presumptively mandatory requirements must be justified.

   b. Interpretive publications should be considered (with departures explained).

   c. Other attestation publications have no authoritative status but may be helpful.

5. The eleven attestation standards include:

   a. Five general standards:

      (1) **T**raining and proficiency.

      (2) **I**ndependence.

      (3) **P**erformance/due professional care in planning and performance.

      (4) **P**rofessional, adequate knowledge of subject matter.

      (5) **Y**our belief that the subject matter is capable of evaluation against criteria that are suitable and available to users. Professional judgment

         (a) Suitable criteria must be objective, measurable, complete, and relevant.

b. Two fieldwork standards: Note that I/C is omitted

(1) **P**lanning and supervision.

(2) **A**ppropriate, sufficient evidence to provide a reasonable basis for the conclusion.

c. Four reporting standards:

(1) Identify the **S**ubject matter or the assertion being reported on and the character of the engagement (including the nature and scope of the work and a reference to attestation standards established by the AICPA).

(2) Disclose **S**ignificant reservations about the engagement (i.e., unresolved problems in complying with attestation standards and/or completing appropriate procedures, or unresolved concerns about the assertion, the subject matter, conformity with criteria, or adequacy of disclosure).

(3) **E**xpress conclusions about the subject matter or the assertion in relation to the established or stated criteria.

(4) **R**estrict use of the report to specified parties when:

(a) The criteria are appropriate for or available to only a limited number of parties.

(b) Reporting on subject matter and a written assertion has not been provided.

(c) Reporting on an agreed-upon procedures engagement.

**PASS KEY**

An easy way to remember the attestation standards is "TIPPY-PASSER."

## E. Additional Reporting Requirements

In addition to requirements based on the four reporting standards, the following should also be considered.

1. The report may be issued on the assertion itself (e.g., "We have examined management's assertion that the accompanying schedule…") or on the subject matter to which the assertion relates (e.g., "We have examined the accompanying schedule…"). (Presents fairly)

   a. In either case, a written assertion is generally obtained in examination and review engagements.

   b. When there are material misstatements or deviations from the criteria, the report should be modified and the conclusion should be expressed directly on the subject matter. or withdraw

2. If reporting on the assertion, it should accompany the practitioner's report or the assertion should be clearly stated in the report.

No restriction on use is required

3. **Scope Restrictions**

Consider withdrawing

a. **Examination** = Positive assurance

Restrictions on the scope of an examination engagement may result in a qualified opinion, disclaimer of opinion, or in the practitioner's withdrawal from the engagement.

b. **Review** = Negative assurance

Restrictions on the scope of a review engagement that prevent necessary procedures from being performed result in the practitioner's withdrawal from the engagement.

4. Concerns about the assertion, conformity with the criteria, or the adequacy of disclosure can result in a qualified or adverse opinion for an examination engagement, or in a modified conclusion for a review engagement.

## F. Conclusion

The conclusions expressed by the practitioner fall into three groups:

1. **Examination**

A positive opinion, high level of assurance, generally based on a variety of procedures, including search, verification, inquiry, and analysis.

**SAMPLE EXAMINATION REPORT ON A SUBJECT MATTER**

**INDEPENDENT ACCOUNTANT'S REPORT**

We have examined the [*identify the subject matter—for example, the accompanying schedule of investment returns of XYZ Company for the year ended December 31, 20XX*]. XYZ Company's management is responsible for the schedule of investment returns. Our responsibility is to express an opinion based on our examination.

Our examination was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants and, accordingly, included examining, on a test basis, evidence supporting [*identify the subject matter—for example, XYZ Company's schedule of investment returns*] and performing such other procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion.

[*Additional paragraph(s) may be added to emphasize certain matters relating to the attest engagement or the subject matter.*]

In our opinion, the schedule referred to above presents, in all material respects, [*identify the subject matter—for example, the investment returns of XYZ Company for the year ended December 31, 20XX*] based on [*identify criteria—for example, the ABC criteria set forth in Note 1*].

[*Signature*]

[*Date*]

**SAMPLE EXAMINATION REPORT ON AN ASSERTION ABOUT A SUBJECT MATTER**

**INDEPENDENT ACCOUNTANT'S REPORT**

We have examined management's assertion that *[identify the assertion—for example, the accompanying schedule of investment returns of XYZ Company for the year ended December 31, 20XX is presented in accordance with ABC criteria set forth in Note 1]*. XYZ Company's management is responsible for the assertion. Our responsibility is to express an opinion on the assertion based on our examination.

Our examination was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants and, accordingly, included examining, on a test basis, evidence supporting management's assertion and performing such other procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion.

[*Additional paragraph(s) may be added to emphasize certain matters relating to the attest engagement or the assertion.*]

In our opinion, management's assertion referred to above is fairly stated, in all material respects, based on [*identify established or stated criteria—for example, the ABC criteria set forth in Note 1*].

[*Signature*]

[*Date*]

2. **Review** *(negative assurance)*

Moderate level of assurance, generally based on inquiry and analytical procedures.

**SAMPLE REVIEW REPORT ON A SUBJECT MATTER**

**INDEPENDENT ACCOUNTANT'S REPORT**

We have reviewed the [*identify the subject matter—for example, the accompanying schedule of investment returns of XYZ Company for the year ended December 31, 20XX*]. XYZ Company's management is responsible for the schedule of investment returns.

Our review was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants. A review is substantially less in scope than an examination, the objective of which is the expression of an opinion on [*identify the subject matter—for example, XYZ Company's schedule of investment returns*]. Accordingly, we do not express such an opinion.

[*Additional paragraph(s) may be added to emphasize certain matters relating to the attest engagement or the subject matter.*]

Based on our review, nothing came to our attention that caused us to believe that the [*identify the subject matter—for example, schedule of investment returns of XYZ Company for the year ended December 31, 20XX*] is not presented, in all material respects, in conformity with [*identify the criteria—for example, the ABC criteria set forth in Note 1*].

[*Signature*]

[*Date*]

**SAMPLE REVIEW REPORT ON AN ASSERTION ABOUT A SUBJECT MATTER**

**INDEPENDENT ACCOUNTANT'S REPORT**

We have reviewed management's assertion that [*identify the assertion—for example, the accompanying schedule of investment returns of XYZ Company for the year ended December 31, 20XX is presented in accordance with the ABC criteria referred to in Note 1*]. XYZ Company's management is responsible for the assertion.

Our review was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants. A review is substantially less in scope than an examination, the objective of which is the expression of an opinion on management's assertion. Accordingly, we do not express such an opinion.

[*Additional paragraph(s) may be added to emphasize certain matters relating to the attest engagement or the assertion.*]

Based on our review, nothing came to our attention that caused us to believe that management's assertion referred to above is not fairly stated, in all material respects, based on [*identify the criteria—for example, the ABC criteria referred to in the investment management agreement between XYZ Company and DEF Investment Managers, Ltd., dated November 15, 20XY*].

This report is intended solely for the information and use of XYZ Company and [*identify other specified parties—for example, DEF Investment Managers, Ltd.*] and is not intended to be and should not be used by anyone other than these specified parties.

[*Signature*]

[*Date*]

Note that the above report is restricted as to use. The last paragraph demonstrates how to indicate this restricted use, and a similar paragraph could be added to any of the other sample reports.

3. **Agreed-upon Procedures**

No assurance, but procedures and findings are listed. A sample agreed-upon procedures report will be shown later in the text.

## G. Written Assertion

A written assertion is generally obtained in examination and review engagements. If no written assertion is provided by management, the outcome depends upon whether the client is also the responsible party.

No written assertion

1. If the client is the responsible party, failure to provide a written assertion constitutes a scope limitation. → Withdraw
   a. In an examination engagement, the report should be modified based on the scope limitation, and its use should be restricted.
   b. A review engagement subject to such a scope limitation is incomplete and the practitioner should withdraw.
2. If the client is not the responsible party, a report may be issued as long as appropriate procedures are performed and sufficient evidence is obtained. However, the form of the report may vary, and its use should be restricted.

### H. Other Requirements

1. Documentation requirements for attestation engagements are similar to those for any other audit or review engagement.
2. An understanding with the client should be established, preferably through a written communication.
3. A representation letter from the responsible party should be obtained for examination and review engagements.
4. Inquiry should be made regarding subsequent events.

## II. AGREED-UPON PROCEDURES ENGAGEMENTS

- Mutual fund performance

Agreed-upon Procedures

An agreed-upon procedures engagement is one in which the practitioner is engaged by a client to issue a report of findings based on specific agreed-upon procedures. It may be performed on the designated subject matter of a wide variety of assertions as a result of a need of specific parties. Attestation standards apply to all agreed-upon procedures engagements, including those related to items from a financial statement. A written assertion generally is not required.

### A. Conditions

Agreed-upon procedures attestation engagements may be performed provided that the following conditions exist:

1. **Independence of the Practitioner**
2. **Agreement of the Parties**

   The practitioner and the specified parties agree regarding the procedures to be performed, the criteria to be used in the determination of the findings, and any materiality limits to be used for reporting purposes.

3. **Measurability and Consistency**

   The subject matter should be capable of reasonably consistent measurement, procedures should be expected to result in reasonably consistent findings, and evidential matter to support the report should be expected to exist.

4. **Sufficiency of the Procedures**

   The specified parties take responsibility for the sufficiency of the procedures for their purposes.

5. **Use of the Report is Restricted to the Specified Parties**
6. **Responsibility for the Subject Matter**

   a. The client is responsible for (or has a reasonable basis for providing an assertion about) the subject matter; or

   b. The client is able to provide evidence that a third party is responsible for the subject matter.

7. **Engagements to Perform Agreed-upon Procedures on Prospective Financial Statements**

   Prospective financial statements must include a summary of significant assumptions.

**PASS KEY**

"I-AM-SURE" you can perform these agreed-upon procedures.

## B. Reporting—*Required Elements*

The practitioner's report on agreed-upon procedures should be in the form of procedures and findings. The practitioner's report should contain the following elements:

1. A title (including the word *independent*), a signature, and a date.
2. Identification of the specified parties, the subject matter (or related assertion), the character of the engagement, and the responsible party.
3. A statement that the subject matter is the responsibility of the responsible party.
4. A statement that the procedures performed were those agreed to by the specified parties identified in the report, and a description of any agreed-upon materiality limits.
5. A statement that the sufficiency of the procedures is solely the responsibility of the specified parties and a disclaimer of responsibility for the sufficiency of those procedures.
6. A statement that the engagement was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants.
7. A list of the procedures performed (or reference thereto) and related findings (the practitioner should not provide negative assurance).
8. A statement that the practitioner was not engaged to, and did not, conduct an examination of the subject matter, a disclaimer of opinion on the subject matter, and a statement that if the practitioner had performed additional procedures, other matters might have come to his or her attention that would have been reported.
9. A statement of restrictions on the use of the report because it is intended to be used solely by the specified parties.
10. Where applicable, reservations or restrictions concerning procedures or findings.
11. Certain additional items for agreed-upon procedures for attestation engagements on prospective financial information. → Assumptions
12. Where applicable, a description of the nature of the assistance provided by a specialist.

## C. Sample Report—*Agreed-upon Procedures*

**INDEPENDENT ACCOUNTANT'S REPORT ON APPLYING AGREED-UPON PROCEDURES**

To the Audit Committees and Managements of ABC Company and XYZ Fund:

We have **performed the procedures enumerated below**, which **were agreed to by the audit committees and managements** of ABC Company and XYZ Fund, solely to assist you in evaluating the accompanying [*description of statement, e.g., Statement of Investment Performance Statistics of XYZ Fund*] (prepared in accordance with the criteria specified therein) for the year ended December 31, 20XX. XYZ Fund's management is responsible for the [*description of statement, e.g., Statement of Investment Performance Statistics of XYZ Fund*]. This agreed-upon procedures engagement was performed in accordance with attestation **standards established by the American Institute of Certified Public Accountants. The sufficiency of these procedures is solely the responsibility of those parties specified in this report.** Consequently, we make no representation regarding the sufficiency of the procedures described below either for the purpose for which this report has been requested or for any other purpose.

*

[*Include paragraphs to enumerate procedures and findings.*]

**We were not engaged to and did not conduct an examination**, the objective of which would be the expression of an opinion on the accompanying [*description of statement, e.g., Statement of Investment Performance Statistics of XYZ Fund*]. Accordingly, we **do not express such an opinion**. Had we performed additional procedures, other matters might have come to our attention that would have been reported to you.

**This report is intended solely for the information and use of the audit committees and managements** of ABC Company and XYZ Fund, and is not intended to be and should not be used by anyone other than these specified parties.

Restricted use

[*Signature*]

[*Date*]

## D. Explanatory Language

The practitioner may include explanatory language regarding matters such as:

1. Disclosure of stipulated facts, assumptions, or interpretations (including the source thereof) used in the application of agreed-upon procedures.
2. Description of the condition of records, controls, or data to which the procedures were applied.
3. Explanation that the practitioner has no responsibility to update his or her report.
4. Explanation of sampling risk.

# III. FINANCIAL FORECASTS AND PROJECTIONS

**Prospective Financial Statements**

Financial forecasts and projections are two types of prospective financial statements that attempt to reflect a company's expected financial position and expected results of operations. Note that pro forma financial statements, which are not considered to be prospective financial statements, show what *past* financial results of an expired period would have been if something had been different.

**A. Financial Forecast** = General & limited use

A financial forecast reflects, to the best of the responsible party's knowledge, the expected financial results of a future period. It is based on *expected* conditions and *expected* courses of action.

*Note:* In almost all situations, the party responsible for the prospective financial statements is the management of the company.

**B. Financial Projection** = Limited use only

A financial projection is different than a forecast in that it is based on *hypothetical* assumptions. A projection reflects the financial position and results of operations based on a *"what if"* type of scenario.

**C. Uses of Prospective Financial Statements**

The uses of prospective financial statements can be categorized as:

**1. General Use**

General use means that the statements issued will be used by parties not negotiating directly with the responsible party (the issuing company). Only a financial forecast is appropriate for general use.

**2. Limited Use**

Limited use means that the financial statements will only be used by the responsible party alone or by parties negotiating directly with the responsible party (the issuing company). Both financial forecasts and financial projections are appropriate for limited use.

**D. Association with Prospective Financial Statements**

A practitioner is associated with prospective financial statements primarily in one of three ways:

1. Compilation engagement No assurance/just assembled OK
2. Examination engagement (the report is generally to be used by a third party) Opinion
3. Agreed-upon procedures engagement Disclaimer

* Note that a review of prospective financial statements is not allowed.

**1. Compilation of Prospective Financial Statements**

| P.F.S. |
|---|
| Compilation |
| Examination |
| Agreed-Upon |

**a. Purpose**

The purpose of a compilation of prospective financial statements is the proper assembling of the financial data based on the responsible party's assumptions.

(1) There is no assurance of any kind given that the statements have been prepared in accordance with AICPA guidelines or that the assumptions used are reasonable.

(2) The accountant should read the prospective financial statements with the summaries of significant assumptions and accounting policies, and consider whether they appear to be presented in conformity with AICPA presentations.

(3) The practitioner is not required to gather supporting evidence, but should be aware of obvious inappropriate assumptions used to construct the statements. Independence is not required, but lack of independence should be disclosed in a separate paragraph in the compilation report. The practitioner is permitted, but not required, to disclose the reason(s) for the lack of independence in the report. All reasons must be included in the disclosure.

(4) A practitioner may not issue a compilation report if the entity fails to disclose a summary of the significant assumptions that are used in the prospective financial statements.

**b. Contents of Compilation Report**

The following items would appear in the practitioner's compilation report:

(1) identification of the prospective financial statements presented by the responsible party;

(2) a statement that the practitioner has **compiled** the prospective financial statements in accordance with attestation standards established by the **AICPA**;

(3) a statement that a compilation is limited in scope and does not enable the practitioner to express an opinion or any other form of assurance on the prospective financial statements or the assumptions;

(4) a caveat that the prospective results **may not be achieved**;

(5) a statement that the practitioner assumes **no responsibility to update** the report for events and circumstances occurring after the date of the report; and

(6) the signature of the practitioner's firm and the date of the report.

**c. Sample Report—*Compilation of a Financial Forecast***

> **We have compiled** the accompanying forecasted balance sheet, statements of income, retained earnings, and cash flows of ABC Company as of December 31, 20XX, and for the year then ending, **in accordance with attestation standards established by the American Institute of Certified Public Accountants**.
>
> A compilation is limited to presenting in the form of forecast information that is the representation of management and does not include evaluation of the support for the assumptions underlying the forecast. We have not examined the forecast and, accordingly, **do not express an opinion or any other form of assurance** on the accompanying statements or assumptions. Furthermore, **there will usually be differences between the forecasted and actual results**, because events and circumstances frequently do not occur as expected, and those differences may be material. **We have no responsibility to update this report** for events and circumstances occurring after the date of this report.
>
> [*Signature*]
>
> [*Date*]

Note: No statement that prospective F/S are in conformity with AICPA guidelines

d. **Compilation of a Financial Projection** = Limited use

The standard report above would be changed slightly to include:

(1) A description of the purpose of the projection at the end of the first paragraph ("The accompanying projection was prepared for…").

(2) A reference to the hypothetical assumption in the second paragraph ("Furthermore, even if [*hypothetical assumption occurs]*, there will usually be differences between the projected and actual results…").

(3) A paragraph restricting the use of the report.

2. **Examination of Prospective Financial Statements**

| P.F.S. |
|---|
| Compilation |
| Examination |
| Agreed-Upon |

An examination of prospective financial statements is more substantial in scope and responsibility than a compilation or an engagement utilizing agreed-upon procedures.

a. **Purpose**

The purpose of an examination of prospective financial statements is to express an opinion as to whether:

(1) the statements are presented in conformity with AICPA guidelines; and

(2) the underlying assumptions provide a reasonable basis for the prospective statements.

b. **Independence Required**

Independence is required for examination engagements.

c. **Evidence Required**

In order for the accountant to make such a claim, sufficient evidence must be obtained. The accountant must evaluate the preparation, support, and presentation of the statements.

d. **Content of Report Based on Examination**

The standard examination report issued by the accountant would contain the following:

(1) A title that includes the word *independent*, the signature of the practitioner's firm, and the date of the report;

(2) Identification of the prospective financial statements presented;

(3) An identification of the responsible party and a statement that the prospective financial statements are the responsibility of the responsible party;

(4) A statement that the practitioner's responsibility is to express an opinion on the prospective financial statements based on his or her examination;

(5) A statement that the examination was conducted in accordance with attestation standards established by the AICPA, and, accordingly, included such procedures as the practitioner considered necessary under the circumstances;

(6) A statement that the practitioner believes that the examination provides a reasonable basis for his or her opinion;

(7) An opinion that the prospective financial statements are presented in conformity with AICPA guidelines and that the underlying assumptions provide a reasonable basis for the forecast or the projection;

(8) A caveat that the prospective results may not be achieved; and

(9) A statement that the practitioner assumes no responsibility to update the report due to subsequent events.

Forecast = General & limited use

(10) For a projection, the report should also include a description of the projection's purpose and a restrictive use paragraph.

Projection = Limited use only

**e. Modifications to the Opinion**

The following issues would require the practitioner to modify the opinion:

Problems

(1) AICPA presentation guidelines are not followed (qualified "except for" or adverse opinion).

(2) Significant assumptions are not disclosed (adverse opinion).

(3) Basis not reasonable: one or more of the significant assumptions do not provide a reasonable basis for the financial statements (adverse opinion).

(4) Scope limitation (disclaimer).

**f. Sample Report—*Examination of a Financial Forecast***

INDEPENDENT ACCOUNTANT'S REPORT

**We have examined** the accompanying forecasted balance sheet, statements of income, retained earnings, and cash flows of X Company as of December 31, 20XX, and for the year then ending. X Company's management is responsible for the forecast. Our responsibility is to express an opinion on the forecast based on our examination.

Our examination was conducted in accordance with **attestation standards established by the American Institute of Certified Public Accountants** and, accordingly, included such procedures as we considered necessary to evaluate both the assumptions used by management and the preparation and presentation of the forecast. We believe that our examination provides a reasonable basis for our opinion.

In our opinion, the accompanying **forecast is presented in conformity with guidelines for presentation of a forecast established by the American Institute of Certified Public Accountants, and the underlying assumptions provide a reasonable basis for management's forecast. However, there will usually be differences between the forecasted and actual results, because events and circumstances frequently do not occur as expected, and those differences may be material. We have no responsibility to update this report for events and circumstances occurring after the date of this report.**

[*Signature*]

[*Date*]

**g. Examination of a Financial Projection**

The standard report above would be changed slightly to include:

(1) A description of the purpose of the projection in the first paragraph ("…management is responsible for the projection, which was prepared for…").

(2) A reference to the hypothetical assumption in the third paragraph ("…provide a reasonable basis for management's projection, assuming [*hypothetical assumption occurs*]. However, even if [*hypothetical assumption occurs*], there will usually be differences…").

(3) A paragraph restricting the use of the report.

**3. Agreed-upon Procedures Applied to Prospective Financial Statements**

| P.F.S. |
|---|
| Compilation |
| Examination |
| Agreed-Upon |

The preceding discussion regarding conditions and required elements for agreed-upon procedures engagements (II.A. and II.B.) also applies when such engagements are related to prospective financial statements. An additional condition is that the prospective financial statements must include a summary of significant assumptions. Additional reporting elements include a reference to the prospective financial statements, a disclaimer on whether the statements are presented in conformity with AICPA guidelines and on whether the underlying assumptions provide a reasonable basis for the statements, a caveat that prospective results may not be achieved, and a statement that the accountant assumes no responsibility to update the report for events occurring after the date of the report.

**E. Partial Presentations**

A presentation of prospective financial information that excludes certain essential elements is considered to be a partial presentation that generally is not appropriate for general use. Limited use only

Partial presentations are those that omit one of the following essential elements: sales, gross profit (or cost of sales), unusual or infrequent items, income tax expense, discontinued operations, extraordinary items, income from continuing operations, net income, earnings per share, and significant changes in financial position.

**F. Prospective Financial Statement Summary**

| *General Procedures* | *Compilation Report* | *Examination Report* | *Agreed-upon Procedures* |
|---|---|---|---|
| Prospective financial statements | Assemble | Evaluate | Apply specific procedures |
| Responsible party's assumptions | Assemble | Evaluate | Should be included in PFS |
| Are financial statements and significant assumptions in conformance with AICPA guidelines? | Look for obvious errors | Opinion | Disclaimer |
| Obtain agreed-upon scope from specified users | -- | -- | Yes |

Review for homework

Review for homework

| *Reports Include a Statement Regarding:* | *Compilation Report* | *Examination Report* | *Agreed-upon Procedures* |
|---|---|---|---|
| Identification of PFS | Yes | Yes | Yes |
| Compliance with AICPA standards | Yes | Yes | Yes |
| Limitation of scope of examination | Yes | -- | Yes |
| An enumeration of procedures performed | -- | -- | Yes |
| A caveat that prospective results may not be achieved | Yes | Yes | Yes |
| CPA has no responsibility for updating report | Yes | Yes | Yes |
| PFS conformity with AICPA presentation guidelines | -- | Yes | -- |
| Limited use of report | Only required for projection | Only required for projection | Yes |

## IV. PRO FORMA FINANCIAL STATEMENTS

Pro forma financial statements are not prospective financial statements, but they may be used to demonstrate the effect of a future or hypothetical event by showing how it might have affected the historical financial statements if it had occurred during the period covered by those financial statements.

A. Pro forma financial statements may be examined or reviewed.

Do not re-evaluate I/C
Determine math/computations are correct

B. The practitioner should obtain an understanding of the event and evaluate the pro forma adjustments, including any assumptions on which the adjustments are based. The practitioner should also obtain written representations from management.

C. A practitioner's report should make reference to the financial statements from which the historical financial information is derived, and state whether such financial statements were audited or reviewed.

## D. Sample Report—*Examination of Pro Forma Financial Statements*

Read for homework

**INDEPENDENT ACCOUNTANT'S REPORT**

We have **examined the pro forma adjustments** reflecting the transaction [*or event*] described in Note 1 and the application of those adjustments to the historical amounts in [*the assembly of*] the accompanying pro forma financial condensed balance sheet of XYZ Company as of December 31, 20X5, and the pro forma condensed statement of income for the year then ended. The historical condensed financial statements are derived from the historical financial statements of XYZ Company, which were audited by us, appearing elsewhere herein [*or incorporated by reference*]. Such pro forma adjustments are based on management's assumptions described in Note 2. XYZ Company's management is responsible for the pro forma financial information. Our responsibility is to express an opinion on the pro forma financial information based on our examination.

Our examination was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants and, accordingly, included such procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion.

The objective of this pro forma financial information is to show what the significant effects on the historical financial information might have been had the transaction [*or event*] occurred at an earlier date. However, the pro forma condensed financial statements are not necessarily indicative of the results of operations or related effects on financial position that would have been attained had the above-mentioned transaction [*or event*] actually occurred earlier.

[*Additional paragraph(s) may be added to emphasize certain matters relating to the attest engagement or the subject matter.*]

In our opinion, management's assumptions provide a reasonable basis for presenting the significant effects directly attributable to the above-mentioned transaction [*or event*] described in Note 1, the related pro forma adjustments give appropriate effect to those assumptions, and the pro forma column reflects the proper application of those adjustments to the historical financial statement amounts in the pro forma condensed balance sheet as of December 31, 20X5, and the pro forma condensed statement of income for the year then ended.

[*Signature*]

[*Date*]

Read for homework

### E. Sample Report—*Review of Pro Forma Financial Statements*

INDEPENDENT ACCOUNTANT'S REPORT

We have **reviewed the pro forma adjustments** reflecting the transaction [*or event*] described in Note 1 and the application of those adjustments to the historical amounts in [*the assembly of*] the accompanying pro forma financial condensed balance sheet of XYZ Company as of December 31, 20X5, and the pro forma condensed statement of income for the year then ended. The historical condensed financial statements are derived from the historical financial statements of XYZ Company, which were audited by us, appearing elsewhere herein [*or incorporated by reference*]. Such pro forma adjustments are based on management's assumptions described in Note 2. XYZ Company's management is responsible for the pro forma financial information.

Our review was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants. A review is substantially less in scope than an examination, the objective of which is the expression of an opinion on management's assumptions, the pro forma adjustments and the application of those adjustments to historical financial information. Accordingly, we do not express such an opinion.

The objective of this pro forma financial information is to show what the significant effects on the historical financial information might have been had the transaction [*or event*] occurred at an earlier date. However, the pro forma condensed financial statements are not necessarily indicative of the results of operations or related effects on financial position that would have been attained had the above-mentioned transaction [*or event*] actually occurred earlier.

[*Additional paragraph(s) may be added to emphasize certain matters relating to the attest engagement or the subject matter.*]

Based on our review, nothing came to our attention that caused us to believe that management's assumptions do not provide a reasonable basis for presenting the significant effects directly attributable to the above-mentioned transaction [*or event*] described in Note 1, that the related pro forma adjustments do not give appropriate effect to those assumptions, or that the pro forma column does not reflect the proper application of those adjustments to the historical financial statement amounts in the pro forma condensed balance sheet as of December 31, 20X5, and the pro forma condensed statement of income for the year then ended.

[*Signature*]

[*Date*]

## V. REPORTING ON AN ENTITY'S CONTROL OVER FINANCIAL REPORTING

A practitioner may be engaged to perform an examination (audit) of an entity's internal controls over financial reporting that is integrated with an audit of its financial statements. This type of attestation engagement will be discussed in Auditing 5. The practitioner may also perform an agreed-upon procedures engagement.

## VI. COMPLIANCE ATTESTATIONS

A practitioner may be engaged to report on compliance with the requirements of specific laws, regulations, rules, contracts, or grants, the effectiveness of an entity's internal control over compliance, or both. The practitioner will generally perform an agreed-upon procedures engagement, but may perform an examination. A review should not be performed. Reporting requirements are similar to those discussed previously, with the following additions:

### A. Agreed-upon Procedures

The report should include a statement that the procedures were performed to assist the specified parties in evaluating the entity's compliance.

### B. Examination

The report should include a statement that the examination does not provide a legal determination on the entity's compliance.

## VII. MANAGEMENT'S DISCUSSION AND ANALYSIS → Required by SEC for "issuers"

A CPA's attest function may include examining or reviewing the Management's Discussion and Analysis (MD&A) report that management of a public company issues with audited financial statements. The requirements for MD&A are established by the SEC. The CPA must obtain an understanding of these requirements before undertaking an examination or review of the MD&A.

# AUDITING 3

*Engagement Acceptance, Planning, and Risk Assessment*

## NOTES

# ENGAGEMENT ACCEPTANCE AND UNDERSTANDING THE ASSIGNMENT

Appointment of the Auditor

## I. APPOINTMENT OF THE AUDITOR

### A. Audit Committees

The audit committee of the client's board of directors is responsible for the selection and appointment of the independent external auditor, and for reviewing the nature and scope of the engagement.

General rule
- SOX applies to "public" companies
- Exam will state "issuer" or "public co."

#### 1. Sarbanes-Oxley Act

a. Under the Sarbanes-Oxley Act (generally applying to issuers), the auditor reports to and is overseen by the client's audit committee.

b. The audit committee must pre-approve all services provided by the auditor.

c. Certain specified non-audit services (covered in Auditing 6) are prohibited.

#### 2. Those Charged With Governance

The term "those charged with governance" refers to those who bear responsibility to oversee the obligations, financial reporting process, and strategic direction of an entity. This term is broadly interpreted to encompass the terms "board of directors" and "audit committee."

#### 3. Required Communications

The auditor is required to communicate certain matters to those charged with governance. These communications are further discussed in Auditing 5.

### B. Timing

Although early appointment of the auditor allows the auditor to plan a more efficient audit, an auditor is permitted to accept an engagement near or after year-end. The auditor should consider whether late appointment will pose limitations on the audit that may lead to a qualified opinion or a disclaimer of opinion, and should discuss such concerns with the client.

### C. Determine the Nature and Scope of the Engagement

The following should be considered as the auditor, the audit committee, and management determine the appropriate nature and scope of the engagement:

1. An auditor may be hired to perform an audit for a single period or multiple periods.
2. If the client is an issuer then the auditor must perform an integrated audit of the client's financial statements and internal controls over financial reporting. Integrated audits may also be performed for nonissuers (integrated audits are further discussed in Auditing 5).
3. Many audit firms are hired to perform tax services in addition to audit services.
4. Government entities and firms that receive federal financial assistance are subject to additional engagement requirements (government audits are discussed in Auditing 6).
5. When auditing nonissuers, the auditor must determine if an audit is the most appropriate engagement, or whether a review or compilation may be more appropriate.

## II. CONSIDER FIRM CLIENT ACCEPTANCE AND CONTINUANCE POLICIES

As part of the pre-acceptance phase of the engagement, the auditor should consider and document compliance with the firm's quality control policies and procedures related to client acceptance and continuance. Specifically, the auditor should assess the following:

### A. Firm's Ability to Meet Reporting Deadlines

A firm should not accept or continue a client relationship unless the firm believes that it has the ability to perform the engagement within reporting deadlines. The firm's ability to meet reporting deadlines is affected by many factors, including the timing and complexity of the engagement and the availability of audit staff.

### B. Firm's Ability to Staff the Engagement

The firm must have personnel with both the experience and availability to meeting staffing and supervision requirements. It may be more difficult to staff an engagement during "busy season" than at other times of the year.

### C. Independence

Independence is required for all audit engagements, as well as for review and attestation engagements. Independence is not necessarily required for compilation engagements. Before accepting or continuing a client relationship when independence is required to be maintained, the firm must ensure that it is in fact independent of the client and that it will be able to maintain independence throughout the engagement.

### D. Integrity of Client Management

The likelihood of financial statement misrepresentation increases when the client's management lacks integrity. The audit firm should minimize the likelihood of association with a client whose management lacks integrity by considering the reputation of the client, its owners, key management, related parties, those charged with governance, the nature of the client's operations, and the client's overall attitude towards matters such as internal controls and the aggressive application of accounting principles.

### E. Group Audits

The group engagement partner should evaluate whether the group engagement team will be able to obtain sufficient appropriate audit evidence through the group engagement team's work or the work of component auditors to act as the auditor of the group financial statements.

## III. ESTABLISH THE PRESENCE OF THE PRECONDITIONS FOR AN AUDIT

Before accepting an audit engagement with a new or existing audit client, the auditor should establish that the preconditions for an audit are present. If the preconditions for an audit are not present, the auditor should not accept the proposed engagement, unless the auditor is required by law or regulation to do so.

## A. Preconditions for an Audit

### 1. Applicable Financial Reporting Framework

The auditor should determine whether the financial reporting framework used by the client is acceptable. Factors related to the acceptability of the financial reporting framework include:

a. The nature of the entity (e.g. business, government, or not-for-profit)

b. The purpose of the financial statements (e.g. wide or narrow range of users)

c. The nature of the financial statements (e.g. complete set or single financial statement)

d. Whether law or regulation prescribes the framework

### 2. Management Responsibilities

The auditor should obtain the agreement of management that it acknowledges and understands its responsibility:

a. for the preparation and fair presentation of the financial statements in accordance with the applicable financial reporting framework;

b. for the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error; and

c. to provide the auditor with:

(1) access to all information of which management is aware that is relevant to the preparation and fair presentation of the financial statements;

(2) additional information that the auditor may request from management for the purpose of the audit; and

(3) unrestricted access to persons within the entity from whom the auditor determines it is necessary to obtain audit evidence.

## B. Management-Imposed Scope Limitation

The auditor should not accept an engagement if, prior to engagement acceptance, management or those charged with governance impose a scope limitation that will result in the auditor disclaiming an opinion on the financial statements as a whole.

### 1. Audit Required by Law or Regulation

If the entity is required by law or regulation to have an audit and a disclaimer of opinion is acceptable, such as in the audit of an employee benefit plan, the auditor is permitted, but not required, to accept the engagement when there is a management imposed scope limitation.

### 2. Scope Limitations That Do Not Preclude Engagement Acceptance

If a management imposed scope limitation will result in a qualified opinion, or if the scope limitation is imposed by circumstances beyond management's control, the auditor may still accept the engagement.

Lack of records = Scope limitation

## IV. AGREEMENT ON AUDIT ENGAGEMENT TERMS (ENGAGEMENT LETTER) = Signed agreement

The auditor should agree to the terms of the engagement with management or those charged with governance, as appropriate. This agreement should be documented in an engagement letter or other suitable form of written agreement. If the auditor believes an agreement with the client has not been established, he or she should decline to accept or perform the engagement. The engagement letter should be accepted (signed and dated) by the client and included with the auditor's documentation.

### A. Reasons for Agreement

A written agreement reduces the risk that either the auditor or the client may misinterpret the needs or expectations of the other party. For example, an agreement reduces the risk that the client may inappropriately rely on the auditor to:

1. protect the entity against certain risks (e.g., defalcations); or
2. perform certain functions (e.g., establishing and maintaining effective internal control over financial reporting) that are the client's responsibility.

### B. Engagement Letter Contents

Engagement letter contents vary for each entity. The agreement may include overall audit strategy, but typically would not include specific audit procedures (unless those procedures were requested by the client).

Audit is subject to inherent limitations/risks that errors & fraud will not be detected

If discovered CPA must report

#### 1. Required Contents

The engagement letter should include:

Fraud
- FS fraud
- Asset misappropriation
- Corruption

a. The objective and scope of the audit.

b. The responsibilities of the auditor.

c. The responsibilities of management (see the Preconditions for an Audit).

d. A statement that because of the inherent limitations of an audit, together with the inherent limitations of internal control, an unavoidable risk exists that some material misstatements may not be detected, even though the audit is properly planned and performed in accordance with GAAS.

e. Identification of the applicable financial reporting framework.

f. Reference to the expected form and content of any reports to be issued by the auditor and a statement that circumstances may arise in which a report may differ from its expected form and content.

#### 2. Other Contents

The engagement letter may also refer to the following:

a. Elaboration of the scope of the audit, including reference to applicable legislation, regulations, GAAS, or ethical requirements.

b. The form of any other communication of results of the audit engagement.

c. Arrangements regarding planning and audit performance, including the composition of the audit team.

d. The expectation that management will provide written representations.

e. The agreement of management to make information available to the auditor in a timely manner.

- Timing
- Client assistance
- Document availability

f. The agreement of management to inform the auditor about subsequent events.

g. Fees and billing arrangements.

h. Arrangements concerning the involvement of other auditors, specialists, internal auditors, or other staff of the entity.

i. Arrangements to be made with the predecessor auditor.

j. Any restriction on the auditor's liability (when not prohibited).

k. Any obligations of the auditor to provide audit documentation to other parties.

l. Additional services to be provided or references to further agreements between the auditor and the entity.

**PCAOB STANDARDS—GUIDANCE FOR ISSUERS**

For audits of issuers, the auditor must agree to the terms of the engagement with the audit committee in an engagement letter. The engagement letter should be provided to the audit committee annually.

## V. RECURRING AUDITS

A recurring audit is an audit engagement for an existing audit client for whom the auditor performed the preceding audit.

### A. Revising the Terms of the Engagement

On recurring audits, the auditor should assess whether circumstances require the terms of the engagement to be revised. The following factors may make it appropriate to revise the terms of the engagement:

1. Any indication that management misunderstands the objective or scope of the audit.
2. Any revised or special engagement terms.
3. A change in senior management.
4. A significant change in ownership.
5. A significant change in the nature or size of the entity's business.
6. A change in legal or regulatory requirements.
7. A change in financial reporting framework.
8. A change in other reporting requirements.

### B. Terms of the Engagement Not Revised

If the auditor concludes that the terms of the engagement do not need to be revised, the auditor should remind management of the terms of the engagement by means of a new engagement letter, or a reminder that the terms of the preceding engagement will govern the current engagement. A reminder can be written or oral and should be documented.

**U.S. AUDITING STANDARDS VS. INTERNATIONAL STANDARDS ON AUDITING**

ISAs require that for recurring audits, the auditor should assess the need to remind the entity of the existing terms of the engagement. U.S. auditing standards require the auditor to review the terms of the engagement with the entity each year.

## VI. INITIAL AUDITS = Talk to old/prior CPA

An initial audit is an engagement in which the financial statements for the prior period were not audited or were audited by a predecessor auditor.

### A. Communication With the Predecessor Auditor Before Engagement Acceptance : mandatory

A predecessor auditor is one who was engaged to audit a prior financial statement (even if the audit was not completed). In an initial audit, including a reaudit engagement, it is mandatory to make inquiries of the predecessor auditor. Client permission is needed, however. If the client is unwilling to agree to this procedure, the auditor should consider the implications and decide whether to accept the engagement.

The auditor should make oral or written inquiries of the predecessor auditor *before* accepting an engagement. Inquiries should be made regarding:

Review prior CPA's WPs (evidence)

1. information that might bear on management integrity;
2. disagreements with management over accounting principles, auditing procedures, or other similarly significant matters;
3. the predecessor's understanding as to the reasons for the change of auditors; and
4. communication to management, the audit committee, and those charged with governance regarding fraud, noncompliance with laws and regulations, and matters relating to internal control.

| U.S. AUDITING STANDARDS VS. INTERNATIONAL STANDARDS ON AUDITING |
|---|
| ISAs do not address the auditor's communication with the predecessor auditor in initial audit or reaudit engagements. |

### B. Opening Balances

#### 1. Auditor's Responsibility

In initial audits and reaudit engagements, the auditor should obtain sufficient appropriate audit evidence about whether:

a. Opening balances contain misstatements that could materially affect the current period financial statements.

b. Accounting policies reflected in the opening balances have been consistently applied in the current period financial statements and whether any changes in accounting policies have been properly accounted for, presented, and disclosed in accordance with the applicable financial reporting framework.

#### 2. Audit Procedures

In order to obtain sufficient appropriate evidence regarding opening balances, the auditor should:

a. Read the most recent financial statements, if any, and the predecessor auditor's report.

(1) If a modification was made to the predecessor auditor's opinion, the auditor should consider the effect of the matter giving rise to the modification on the current period assessment of the risks of material misstatement. If the modification of the predecessor auditor's opinion is relevant to the current period's financial statements, the auditor should modify the auditor's opinion on the current period's financial statements.

WPs = Documentation = Evidence

b. Request management to authorize the predecessor auditor to allow a review of the predecessor auditor's audit documentation related to the most recently completed audit.

(1) The predecessor auditor ordinarily permits the auditor to review documentation of planning, risk assessment procedures, further audit procedures, audit results, and other matters of continuing accounting and audit significance.

c. Perform audit procedures on current period transactions that provide evidence about the opening balances or consistency.

**3. Auditor Remains Responsible**

While the current period auditor may consider information obtained from the review of the predecessor's audit documentation, the auditor remains solely responsible for the audit work performed and the conclusions reached during the current audit. The auditor should not make reference to the report or work of the predecessor auditor as the basis for the auditor's opinion.

**4. Discovery of Material Misstatements in Opening Balances**

If the auditor obtains audit evidence that opening balances contain misstatements, the auditor should determine the effect on the current period financial statements. If the auditor believes that the financial statements reported on by the predecessor auditor require revision, the auditor should ask the client to arrange a meeting (involving both auditors and the client) to resolve the matter. If the client's management refuses to inform the predecessor auditor, or if the auditor is not satisfied with the resolution, the auditor should consider the implications on the current audit and whether to resign from the engagement.

**5. Effect on the Auditor's Report**

**a. Qualified or Disclaimer** = GAAS issue

The inability of the auditor to obtain sufficient appropriate audit evidence regarding opening balances may result in one of the following report modifications:

(1) A qualified opinion or a disclaimer of opinion, as appropriate.

(2) An opinion that is qualified or disclaimed, as appropriate, regarding the results of operations and cash flows, and unmodified regarding financial position.

**b. Qualified or Adverse** = GAAP issue

A qualified or adverse opinion should be expressed if:

(1) The opening balances contain a misstatement that materially affects the current period financial statements, and the effect of the misstatement is not appropriately accounted for or adequately presented or disclosed.

(2) The current period's accounting policies are not consistently applied regarding opening balances.

(3) A change in accounting policy is not properly accounted for or adequately presented or disclosed.

Planning

# I. PLANNING AND SUPERVISION

## A. Overview of Planning

During planning, the auditor is required to:

1. Obtain knowledge of the client's business and industry.
2. Develop the audit strategy.
3. Develop the audit plan.
4. Perform risk assessment procedures to obtain an understanding of the entity and its environment, including its internal control, sufficient to assess the risks of material misstatement and design further audit procedures.

**PASS KEY**

The auditor plans the audit to be responsive to the initial assessment of the risk of material misstatement, but should be prepared to revise the audit strategy and the audit plan based on the results of audit procedures.

**PCAOB STANDARDS—GUIDANCE FOR ISSUERS**

PCAOB standards state that the nature and extent of necessary planning activities depend on the size and complexity of the company, the auditor's previous experience with the company, and changes in circumstances that occur during the audit. Factors that indicate less complex operations include fewer business lines, less complex business processes and financial reporting systems, more centralized accounting functions, extensive involvement of senior management in day-to-day operations, and few levels of management.

## B. Involvement of Key Engagement Team Members

The engagement partner and other key members of the engagement team should be involved in planning the audit. The engagement partner is the member of the engagement team with primary responsibility for the audit. The engagement partner is responsible for:

1. Planning the audit.
2. Supervising the work of engagement team members.
3. Compliance with relevant auditing standards.

The engagement partner may seek assistance from appropriate engagement team members in fulfilling these responsibilities.

CPA documents evidence to support → Express opinion

## C. Supervision of Assistants

Supervision

GAAS requires proper supervision of assistants during the course of the audit to ensure that the work performed is adequate to accomplish the objectives of the examination and is consistent with conclusions presented in the report. Guidance should be provided to assistants regarding both technical and personnel aspects of the audit.

### 1. Proper Supervision

When assistants are used, proper supervision includes:

a. directing the efforts of assistants;

b. communicating with the audit team regarding the susceptibility of the financial statements to material misstatement due to error or fraud;

c. informing assistants of their responsibilities, the objectives of the procedures they are to perform, the nature, timing, and extent of procedures they are to perform, and any matters that may affect their performance of those procedures;

d. staying informed (e.g., by directing staff to report back) regarding significant accounting and auditing issues, new developments, and difficulties encountered in performing the audit, and evaluating whether appropriate action has been taken in accordance with applicable standards (SAS or PCAOB);

e. reviewing the work performed by assistants to determine whether it was adequately performed and documented, whether the objectives of the audit were accomplished, and whether the work performed is consistent with the conclusions to be presented in the auditor's report; and

f. dealing with differences of opinion among members of the audit team.

The "NET" the auditor uses to cover the client's records & internal control

**2. Nature, Extent, and Timing of Supervision**

The nature, extent, and timing of the supervision depend upon:

a. The size and complexity of the entity

b. The nature of the work assigned

c. The assessed risks of material misstatement

d. The qualifications of the assistants.

**3. Disagreements With Assistants**

A disagreement among members of the audit team regarding certain accounting and auditing issues may exist at the end of the audit. If the differences still exist after consulting with the auditor who has final responsibility for the audit (generally a partner), dissenting staff members should be allowed to disassociate themselves from the resolution by documenting their disagreement. In this event, the basis for the final resolution should also be documented.

## II. KNOWLEDGE OF THE CLIENT'S BUSINESS AND INDUSTRY

The auditor is not required to have prior experience with a client's business or industry before accepting the engagement. However, once the engagement has been accepted, the auditor must obtain an understanding of the client's industry and business.

### A. Knowledge of the Client's Industry

Obtaining knowledge about the client's industry helps to highlight practices unique to that industry that may have an effect on the client's financial statements. The most common sources of industry information are:

1. AICPA accounting and audit guides;
2. trade publications and professional trade associations;
3. government publications; and
4. AICPA Accounting Trends and Techniques (an annual survey of accounting practices).

## B. Knowledge of the Client's Business

The auditor should obtain knowledge relating to the client's business before commencing the audit. Understanding the client's business provides information regarding events and transactions that may affect the client's financial statements. The auditor may:

### 1. Tour Client Facilities

A tour of the client's facilities gives the auditor an excellent opportunity to meet the client's personnel and observe the general operation of the company. A well-organized tour can often save the auditor much time and effort during the course of the audit. As a practical matter, this step is most important for new client relationships.

### 2. Review the Financial History of the Client

The auditor should review written documents relating to the current and past financial history of the client. These may include:

a. previous audit reports;

b. annual and permanent audit files;

c. prior year and interim financial statements;

d. minutes of stockholders' and board of directors' meetings;

e. communications with third parties;

f. SEC filings;

g. Dun and Bradstreet reports; and

h. tax returns.

### 3. Obtain an Understanding of Client Accounting

The auditor should obtain an understanding of client accounting methodology because it affects the design of internal control, which in turn impacts planned audit procedures. Specifically, the auditor should obtain an understanding of:

a. Methods used to gather and process accounting information, including the extent to which computer processing is used and the use of any outside service organization. Such methods influence the client's design of internal control and the auditor's consideration thereof. Review of the client's policies and procedures manual often provides information about client accounting.

b. Events and transactions that may affect the financial statements or require special audit consideration.

c. Other factors affecting audit risk, such as related party transactions.

d. Applicable accounting and auditing pronouncements.

### 4. Inquire of Client Personnel

The auditor should inquire about current business developments affecting the entity.

## III. DEVELOPING THE AUDIT STRATEGY

### A. Overall Audit Strategy → Written ← Nature Extent Timing

The audit strategy outlines the scope of the audit engagement, the reporting objectives, timing of the audit, required communications, and the factors that determine the focus of the audit. The audit strategy also includes a preliminary assessment of materiality and tolerable misstatement.

Developing the audit strategy early in the audit process helps the auditor determine the resources needed to complete the audit, including:

1. The involvement of other auditors, specialists, and the client's internal auditors.
2. The assignment of staff to specific audit areas, including the assignment of more experienced staff to higher risk areas.
3. The timing of testing (interim vs. year-end) and audit team meetings.
4. The budget hours to assign to specific audit areas.
5. The extent, location, and timing of reviews of audit work.

### B. Scope of the Audit = Extent

The characteristics that define the scope of the audit include:

1. Characteristics of the engagement, including the basis of reporting, reporting currency, and locations of the entity.
2. Industry-specific, regulatory, and statutory reporting requirements.
3. The size and complexity of the entity to be audited, including parent-subsidiary relationships.
4. The effect of information technology on the audit.
5. Knowledge gained from prior experience with the entity.
6. The use of service organizations by the entity.

### C. Reporting Objectives, Audit Timing, and Required Communications = Timing

The following matters should be considered when determining the audit reporting objectives, timing, and required communications:

1. Deadlines for interim and final reporting.
2. Key dates for meetings with management and those charged with governance.
3. The expected type and timing of reports and other communications.
4. The nature and timing of audit team communications, including audit team meetings and reviews of audit work.
5. Expected or required communications with third parties.

### D. Factors That Determine the Focus of the Audit = Nature

The factors that determine the focus of the audit team's efforts include:

1. Preliminary evaluations of materiality, audit risk, and internal control. → To develop an overall audit strategy
2. Material locations and account balances.
3. Areas where there is a higher risk of material misstatement.
4. Significant business and industry developments and accounting changes.
5. Management's commitment to the design and operation of internal controls.

**PCAOB STANDARDS—GUIDANCE FOR ISSUERS**

PCAOB standards state that when establishing an overall audit strategy, the auditor should consider whether the following items are important to the company's financial statements and internal control over financial reporting:

- Knowledge of the company's internal control over financial reporting obtained during other engagements performed by the auditor.
- Matters affecting the industry in which the company operates, such as financial reporting practices, economic conditions, laws and regulations, and technological changes.
- Matters relating to the company, including its organization, operating characteristics, and capital structure.
- The extent of recent changes in the company, its operations, or internal control over financial reporting.
- The auditor's preliminary judgments about materiality, risk, and, in integrated audits, other factors relating to the determination of material weaknesses.
- Control deficiencies previously communicated to the audit committee or management.
- Legal or regulatory matters of which the company is aware.
- The type and extent of evidence related to the effectiveness of internal control over financial reporting.
- Preliminary judgments about the effectiveness of internal control over financial reporting.
- Public information about the company relevant to the evaluation of the likelihood of material financial statement misstatements and the effectiveness of the company's internal control over financial reporting.
- Knowledge about risks related to the company evaluated as part of the auditor's client acceptance and retention evaluation.
- The relative complexity of the company's operations.

If any of these matters are important, the auditor must evaluate how they will affect the auditor's procedures.

## E. Materiality and Tolerable Misstatement

When establishing the audit strategy, the auditor should determine materiality for the financial statements as a whole, performance materiality, and, when necessary, materiality levels for particular classes of transactions, account balances or disclosures.

### 1. Materiality

The auditor should determine the materiality level for the financial statements as a whole.

**PASS KEY**

The Supreme Court of the United States has held that a fact is material if there is "a substantial likelihood that the . . . fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information available." The Supreme Court has also noted that determinations of materiality require "delicate assessments of the inferences a 'reasonable shareholder' would draw from a given set of facts and the significance of those inferences to him . . ."

#### a. Needs of Users

Materiality is influenced by the auditor's perception of the needs of financial statement users. Users are assumed to:

(1) Have appropriate knowledge of business, the economy, and accounting.

(2) Recognize that financial statements inherently include some level of uncertainty.

(3) Understand how materiality affects both the preparation and audit of the financial statements.

(4) Have both a willingness and an ability to properly analyze the financial statements, and to make appropriate decisions based on this analysis.

**b. Materiality for the Financial Statements as a Whole**

Materiality is based on professional judgment. Both qualitative and quantitative factors must be considered when setting materiality for the financial statements as a whole. The materiality level for the financial statements as a whole needs to be expressed as a specified amount. When assessing materiality, the auditor should use the smallest level of misstatement that could be material to any one of the financial statements.

| PCAOB STANDARDS—GUIDANCE FOR ISSUERS |
|---|
| PCAOB standards state that ordinarily it is not practical to design audit procedures to detect misstatements that are material based solely on qualitative factors. |

Consider quantitative & qualitative judgment

The following factors are used to make the preliminary assessment of materiality:

(1) The application of a percentage to an appropriate financial statement benchmark. The financial statements used may be the entity's annualized interim financial statements or its prior period annual financial statements. When identifying the appropriate benchmark to use to calculate materiality, the auditor should consider:

(a) Whether there are financial statement items on which users focus their attention when evaluating the entity's financial position or performance.

(b) The nature of the entity and its industry.

(c) The size of the entity, the nature of its ownership, and its methods of financing.

(d) Examples of materiality benchmarks include total revenue, gross profit, profit before tax from continuing operations, and net assets.

(2) Prior period financial results, period-to-date financial results and position, and current period budgets and forecasts.

(3) Any significant known or expected changes in the entity's circumstances.

(4) Changes in the conditions of the industry or the economy as a whole.

| PCAOB STANDARDS—GUIDANCE FOR ISSUERS |
|---|
| PCAOB standards state that separate lower materiality levels should be set for particular accounts or disclosures when there is a substantial likelihood that misstatements of amounts less than the materiality level established for the financial statements as a whole would influence the judgment of a reasonable investor. |

**c. Performance Materiality**

Performance materiality is the amount or amounts set by the auditor at less than materiality for the financial statements as a whole to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality for the financial statement as a whole. The auditor should determine performance materiality for purposes of assessing the risks of material misstatement and determining the nature, timing, and extent of further audit procedures.

(1) **Tolerable Misstatement**

Tolerable misstatement is the maximum error in a population that the auditor is willing to accept. Tolerable misstatement is the application of performance materiality to a particular sampling procedure.

**PCAOB STANDARDS—GUIDANCE FOR ISSUERS**

PCAOB standards state that in multi-location audits, the auditor should determine tolerable misstatement for the individual locations or business units at an amount that reduces to an appropriately low level the probability that the total of uncorrected and undetected misstatements would result in a material misstatement of the consolidated financial statements. Tolerable misstatement for an individual location should be less than the materiality level for the financial statements as a whole.

Cycle test
3 categories
- Transactions
- Account balances
- Disclosures

- Revenue
- Expenditure
- Inventory
- Investments
- PP&E
- Payroll
- Financing

d. **Materiality for Particular Classes of Transactions, Account Balances, or Disclosures**

In the specific circumstances of an entity, there may be one or more particular classes of transactions, account balances, or disclosures for which misstatements of a lesser amount than materiality for the financial statements as a whole could influence the economic decisions of users. When this is the case, the auditor should determine the separate materiality levels to be applied to those classes of transactions, account balances, or disclosures.

e. **Materiality in Group Audits**

In a group audit, the group engagement team should do the following when making its preliminary assessments of materiality:

(1) Assess materiality, including performance materiality, for the group financial statements as a whole.

(2) Determine materiality to be applied to particular classes of transactions, account balances, or disclosures in the group financial statements for which misstatements of lesser amounts than materiality for the group financial statements as a whole could influence the economic decisions of users.

(3) Determine component materiality for those components on which the group engagement team will perform, or request a component auditor to perform, an audit or review. Component materiality should be determined taking into account all components and should be lower than materiality for the group financial statements as a whole. Component performance materiality should be lower than performance materiality for the group financial statements as a whole.

(4) The threshold above which misstatements cannot be regarded as clearly trivial to the group financial statements.

f. **Revising the Assessment of Materiality** = Change "NET"

The preliminary assessments of materiality ordinarily will be revised as the audit progresses. The auditor should consider whether the audit plan and the nature, extent, and timing of audit procedures need to be modified in response to any change in the assessments of materiality, and should not assume that a misstatement is an isolated occurrence.

**PCAOB STANDARDS—GUIDANCE FOR ISSUERS**

PCAOB standards give the following examples of situations that would require a reevaluation of established materiality levels or tolerable misstatement:

- Materiality levels and tolerable misstatement were originally based on estimated or preliminary financial statement amounts that differ significantly from actual amounts.
- Events or changes (e.g., changes in laws, regulations, the financial reporting framework, or contractual agreements) that occurred after the materiality levels and tolerable misstatement were established are likely to affect investors' perceptions about the company's financial statements.

### F. Small Entities

For a small entity, establishment of an audit strategy may be a simple and less formal process, such as preparing a brief memorandum at the end of one audit and updating it at the beginning of the next.

### G. Communication With Those Charged with Governance

The auditor is required to communicate the planned scope and timing of the audit with those charged with governance (covered further in Auditing 5).

## IV. DEVELOPING THE AUDIT PLAN → Written "NET"

Audit Plan

The audit plan is based on the audit strategy and outlines the nature, extent, and timing of the procedures to be performed during the audit. While creation of an audit plan typically follows development of the audit strategy, the two are closely interrelated and may overlap to some extent.

**PASS KEY**

A written audit plan (i.e., documentation of specific audit procedures) is *required*

### A. Audit Procedures

Audit procedures are performed to obtain evidence on which to base the audit opinion. Audit procedures may be categorized as:

1. **Risk Assessment Procedures** Required in all FS audits

   Risk assessment procedures are used to obtain an understanding of the entity and its environment, including its internal control, in order to assess the risks of material misstatement and determine the nature, extent, and timing of further audit procedures.

   a. Risk assessment procedures alone do not provide audit evidence sufficient to support an audit opinion.

   b. Specific risk assessment procedures will be discussed later in this lecture.

2. **Further Audit Procedures**

   Further audit procedures include tests of the operating effectiveness of internal controls and substantive procedures.

a. **Tests of Controls** = Audit tests internal controls

Tests of control are used to evaluate the operating effectiveness of internal controls in preventing or detecting material misstatements.

(1) Tests of controls are necessary when:

(a) The auditor's risk assessment is based to some extent on the operating effectiveness of internal control.

(b) Substantive procedures alone are deemed to be insufficient (covered later).

b. **Substantive Procedures** = $ubstantive testing

Substantive procedures are used to detect material misstatements. They include tests of details (as applied to transaction classes, account balances, and disclosures) and substantive analytical procedures → At end of audit

(1) Substantive procedures are performed in response to the planned level of detection risk, which in turn may be based (to some extent) on the results of tests of controls.

(2) Since risk assessment is judgmental, and since there are inherent limitations of internal control, substantive procedures are required for all relevant assertions related to each material transaction class, account balance, and disclosure item.

3. **Other Audit Procedures**

Other audit procedures (for example, a letter to the client's attorney) may be necessary to comply with GAAS.

4. **Timing of Audit Procedures**

Management discussion : Type → Nature; Scope → Extent; When → Timing

a. **Testing at an Interim Date**

During planning, the auditor generally establishes the timing of the audit work, which may include the gathering of audit evidence at interim dates. When audit procedures are performed before year-end, the auditor must assess the incremental risk involved and determine whether sufficient alternative procedures exist to extend the interim conclusions to year-end.

b. **Effect of Information Technology**

The auditor should consider the methods used by the client to process accounting information, and whether those methods affect the availability of data. For example, when computer processing is used, documents may exist only briefly because they are discarded once information is entered into the system. In such situations, the auditor may need to schedule audit procedures to coincide with the availability of information. The auditor should also consider performing tests several times during the year.

## B. Financial Statement Assertions

Financial Statement Assertions

Further audit procedures (tests of controls and substantive procedures) are performed at the relevant assertion level for each material account balance, transaction class, and disclosure item in the financial statements.

1. **What Are Financial Statements?**

Financial statements are not statements of facts. They are claims and assertions, made implicitly or explicitly by management, about the recognition, measurement, presentation, and disclosure of information in the financial statements.

## 2. Assertions

There are six main financial statement assertions:

Assertions made by management

C a. **Completeness**

All account balances, transactions, and disclosures that should have been recorded have been recorded and included in the financial statements.

O b. **CutOff**

Transactions have been recorded in the correct (proper) accounting period.

V c. **Valuation, Allocation, and Accuracy**

Account balances, transactions, and disclosures are recorded fairly and at appropriate amounts, and any resulting valuation or allocation adjustments are appropriately recorded.

E d. **Existence and Occurrence**

Account balances exist and transactions that have been recorded and disclosed have occurred and pertain to the entity.

R e. **Rights and Obligations**

The entity holds or controls the rights to assets and liabilities are the obligations of the entity. Account balances & disclosures

U f. **Understandability and Classification**

Transactions have been recorded in the proper accounts. Financial information is appropriately presented and described and disclosures are clearly expressed.

| PASS KEY |
|---|
| The mnemonic "**COVERU**" may be used to aid in your memorization of the financial statement assertions. |

## 3. Relevant Assertions

Relevant assertions are assertions that have a meaningful bearing on whether an account, transaction, or disclosure is fairly stated. In determining whether an assertion is relevant to a particular account, transaction, or disclosure, the auditor should consider the nature of the assertion, the volume of activity related to the assertion, and the nature and complexity of the systems used to process information supporting the assertion.

a. **Transactions and Events** → COVER U

For transactions and events, relevant assertions include completeness, cutoff, accuracy, classification, and occurrence.

b. **Account Balances** → COVER U

For account balances, relevant assertions include completeness, allocation and valuation, rights and obligations, and existence.

c. **Presentation and Disclosure** → COVER U

For presentation and disclosure, relevant assertions include completeness, understandability and classification, rights and obligations, and valuation and accuracy.

| PCAOB STANDARDS—GUIDANCE FOR ISSUERS |
|---|
| PCAOB standards state that the financial statement assertions are:<br>• **C**ompleteness<br>• **E**xistence<br>• **O**ccurrence<br>• **A**llocation<br>• **P**resentation<br>• **R**ights<br>• **O**bligations<br>• **V**aluation<br>• **E**<br>• **D**isclosure<br>The PCAOB assertions are "CEO APROVED."<br>The PCAOB also states that the auditor may base the audit work on different financial statement assertions if the assertions are sufficient for the auditor to identify the types of potential misstatements and to respond appropriately to the risks of material misstatement. |

## C. Use of Assertions

1. An auditor uses relevant assertions to form a basis for assessing risk and for the design and performance of further audit procedures. The auditor should identify potential misstatements that may occur and then design audit procedures to address those risks.

2. The following table provides some examples of the use of relevant assertions in developing audit procedures for inventory.

| *Relevant Assertion* | *Potential Misstatement* | *Audit Procedure* |
|---|---|---|
| Inventories included in the balance sheet physically exist (existence assertion). | The inventory balance includes amounts that don't physically exist (i.e., inventory is overstated). | Physically examine inventory items. |
| Inventory quantities include all inventory on hand (completeness assertion). | Inventory items on hand are excluded from the inventory balance (i.e., inventory is understated). | Observe physical inventory counts. |
| Inventory quantities include all inventory stored at outside locations (completeness assertion). | Inventory items stored at outside locations are excluded from the inventory balance (i.e., inventory is understated). | Obtain confirmation of inventories held at outside locations. |

3. Note that:

   a. There may be more than one relevant assertion related to the same transaction class, account balance, or disclosure.

   b. A given audit procedure may provide evidence supporting more than one assertion. For example, when an auditor obtains confirmation of inventories held at outside locations, evidence is obtained about both the completeness and the existence of inventory.

c. More than one procedure may be required to fully support an assertion. For example, in order to be reasonably certain that inventory quantities include all inventory on hand at year-end, the auditor should also inspect receiving reports near year-end for recording in the proper period.

### D. Drafting the Audit Plan : required (written)

Audit Plan

After sufficient planning information has been gathered, an audit plan should be drafted. A written audit plan is *required* for every audit. The audit plan is a listing of audit procedures that the auditor believes are necessary to accomplish the objectives of the audit. It serves as the work plan for the supervising auditor and assistants working on the engagement. Thus, the audit plan should set out procedures in reasonable detail, specifying the nature, extent, and timing of the work to be performed, and include a reference to the assertion under consideration (this reference may be implied as to the objective).

For example:

"Perform a specified procedure (e.g., count/vouch/trace/compare/calculate/confirm/examine)... – ***nature*** = Type

...on [a specified number of records from a specified population] – ***extent*** = Scope

...as of [some interim date or year-end, either for the entire period or from the date of interim fieldwork]." – ***timing*** = When

As the audit progresses, the initial audit plan may need to be modified in response to changing conditions or the results of other procedures. Modifications are often made after assessing the risks of material misstatement, or based on the results of audit procedures. The audit plan should be designed so that the audit evidence gathered will support the auditor's conclusions.

### E. Group Audit Plan

The group audit team should develop a group audit strategy and a group audit plan. The group audit plan should detail the extent to which the group engagement team will use the work of component auditors and whether the auditor's report on the group financial statements will make reference to the audit of a component auditor.

## V. THE ROLE OF THE CLIENT'S INTERNAL AUDITORS ≠ Judgment

Internal Auditors

Consider
- To whom internal auditors report
- The higher the level the more objectivity can be assumed

When planning the audit, the auditor should consider the extent of involvement of the client's internal auditors in the performance of the audit. While internal auditors must maintain objectivity and integrity, they are not independent of the client, their employer. Thus, the independent external auditor cannot share with the internal auditor any of the responsibility for audit decisions, judgments, or assessments made as part of the audit (such as those concerning materiality or accounting estimates), or any of the responsibility for issuing the report.

### A. Effect of the Internal Auditor's Work

The work of an internal auditor may aid the external auditor in obtaining an understanding of internal control, assessing risk, and performing substantive procedures. In judging the extent of the effect of the internal auditor's work, the CPA should consider the materiality of financial statement amounts, the risks of material misstatement, and the degree of subjectivity involved in evaluating evidence.

1. For assertions related to material financial statement amounts with a high risk of material misstatement or a high degree of subjectivity, the internal auditor's work alone cannot eliminate direct testing by the CPA (e.g., assertions about the valuation of assets/liabilities involving significant accounting estimates, or assertions about the existence/disclosure of related-party transactions, contingencies, uncertainties, and subsequent events).

Judgment & assessment
- CPA/auditor must decide
- Not internal auditor

2. For assertions related to less material financial statement amounts with a low risk of material misstatement or a low degree of subjectivity, direct testing by the CPA may not be necessary (e.g., assertions about the existence of cash, prepaid assets, or fixed asset additions).

**B. Direct Assistance Provided by the Internal Auditor**

An external auditor may request that the internal auditor perform a specific task to aid in the conduct of the audit. The external auditor should supervise, review, evaluate, and test the work performed, and there should be communication between the auditors regarding responsibilities, objectives, and accounting/auditing issues.

**C. External Auditor Responsibilities**

**1. Obtain an Understanding of the Internal Audit Function**

Since internal auditors often review and assess an entity's controls, the internal audit function is considered to be part of the monitoring component of internal control (covered later). The external auditor should therefore obtain an understanding of the internal audit function (scope of activities, procedures used, access to records) and determine whether any internal audit activities are relevant to the audit.

**2. Evaluating the Internal Audit Function**

- Prior experience
- Prior evaluation
- Talk to mgt.

The external auditor may use the internal auditors to provide direct assistance or use the work of the internal audit function in obtaining audit evidence.

**a. Direct Assistance**

If the auditor plans to use the internal auditors to provide direct assistance, the internal auditor's competence and objectivity must be assessed.

**b. Use of Work of Internal Auditor**

The external auditor may be able to use the work of the internal audit function in obtaining audit evidence depending on the competency of the internal audit function, objectivity of the internal auditors, and whether the internal audit function applies a systematic and disciplined approach, including quality control.

(1) Competence is reflected by education, professional certification, experience, performance evaluations, the audit plan, audit procedures, and the quality of internal audit documentation.

(2) Objectivity is reflected by the organizational level to which the internal auditor reports, as well as by policies prohibiting audits of areas where the internal auditor lacks independence.

(3) Application of a systematic and disciplined approach is reflected by the existence, adequacy, and use of documented internal audit procedures or guidance covering such areas as risk assessments, work programs, documentation, and reporting. In addition, the internal audit function may demonstrate a systematic and disciplined approach by applying appropriate quality control policies and procedures or quality control requirements in standards set by relevant professional bodies for internal auditors. (Quality control and related examples are discussed in more detail in Auditing 6 – Topic: *Quality Control Standards*.)

### 3. Supervise and Review

The external auditor should supervise and review all work performed on the audit.

**U.S. AUDITING STANDARDS VS. INTERNATIONAL STANDARDS ON AUDITING**

ISA 610 states that when the external auditor intends to use the work of the internal auditor, the external auditor should evaluate and test that work. U.S. auditing standards state that the auditor should test some of the internal auditor's work related to the significant financial statement assertions. These tests may be accomplished by either (a) examining some of the controls, transactions, or balances that the internal auditors examined or (b) examining similar controls, transactions, or balances not actually examined by the internal auditors.

### 4. Bear Responsibility

The external auditor remains solely responsible for the report on the financial statements. While internal auditors may assist with regard to routine tasks, they may not be utilized to make judgment calls. These remain the responsibility of the independent auditor.

Specialist

## VI. USING THE WORK OF A SPECIALIST

An auditor may decide during planning that it is necessary to use the work of a specialist in order to obtain competent audit evidence related to balances, transactions, or disclosures that are material to the fair presentation of financial statements. In addition, the entity may use the work of a specialist to assist the entity in the preparation of the financial statements.

### A. Who Is a Specialist?

A specialist is a person or firm with special skills in a field other than accounting or auditing (e.g., actuaries, appraisers, attorneys, engineers, etc.).

#### 1. Auditor's Specialist

An auditor's specialist is an individual or organization whose work in a field other than accounting or auditing is used by the auditor to assist in obtaining sufficient appropriate audit evidence. An auditor's specialist may be an internal specialist employed by the auditor's firm or a network firm, or an external specialist.

#### 2. Management's Specialist

Management's specialist is an individual or organization whose work in a field other than accounting or auditing is used by the entity to assist the entity in preparing the financial statements.

### B. Use of an Auditor's Specialist

#### 1. Determining the Need for an Auditor's Specialist

A auditor's specialist may be engaged whenever the auditor believes it is desirable or necessary. For example, specialists may be used to:

a. Value restricted securities and works of art.

b. Determine physical characteristics (e.g., related to mineral reserves or large quantities of fungible goods).

c. Determine specialized estimates, such as actuarial calculations used to determine employee benefit obligations.

d. Interpret technical standards or legal documents.

2. **Understanding the Specialist's Field of Expertise**

   The auditor should have a sufficient understanding of the specialist's field of expertise to enable the auditor to:

   a. determine the nature, scope, and objectives of the work of the auditor's specialist; and

   b. evaluate the adequacy of the specialist's work for the auditor's purposes.

Treat the CPA firm specialist like one of your staff

3. **Competence, Capabilities, and Objectivity**

   The auditor must be satisfied as to the professional competence, capabilities, and objectivity of the specialist. Generally, a specialist who is unrelated to the client will provide the auditor with greater assurance of reliability, although the auditor should inquire regarding interests and relationships that may create a threat to objectivity. A specialist who is related to the client may be acceptable in some circumstances. The auditor should perform additional procedures when a relationship between the entity and the auditor's specialist might impair the objectivity of the specialist.

4. **Agreement With the Auditor's Specialist**

   The auditor should agree, in writing when appropriate, with the auditor's specialist (whether internal or external) regarding:

   a. the nature, scope, and objectives of the work of the auditor's specialist;

   b. the respective roles and responsibilities of the auditor and the auditor's specialist;

   c. the nature, timing, and extent of communication between the auditor and the auditor's specialist; and

   d. the need for the auditor's specialist to observe confidentiality requirements.

5. **Effect on the Auditor's Report**

   If the specialist's findings indicate that the financial statements are not in conformity with GAAP, a qualified or adverse opinion would be issued. An unresolved difference between the specialist's findings and the financial statements, or an unresolved disagreement between the auditor and the specialist, would lead to a qualified opinion or disclaimer of opinion due to a scope limitation. If, as a result of the work performed by the specialist, the auditor decides to express a modified opinion, the auditor may refer to the specialist in the report and should indicate that the reference to the specialist does not reduce the auditor's responsibility for the audit opinion. The auditor may need the permission of the auditor's specialist before making reference to the specialist in the report. If the auditor is expressing an unmodified opinion, no reference should be made to the work of the specialist.

**U.S. AUDITING STANDARDS VS. INTERNATIONAL STANDARDS ON AUDITING**

ISA 620 states that if the auditor decides to issue a modified report as a result of the work of an expert, it may be appropriate in some circumstances to refer to or describe the work of the expert to explain the nature of the modification. In these circumstances, the auditor should obtain permission from the expert before making such a reference. U.S. auditing standards do not require the auditor to obtain the specialist's permission, but instead state that the auditor may need permission.

**C. Use of a Management's Specialist**

Treat the management's specialist like one of your staff

If information to be used as audit evidence is prepared using the work of a management's specialist, the auditor should:

1. evaluate the competence, capabilities, and objectivity of the specialist;
2. obtain an understanding of the work of the specialist; and
3. evaluate the appropriateness of the specialist's work as audit evidence for the relevant assertion.

## AUDIT RISK

Audit Risk

# I. AUDIT RISK

Example

Issue unqualified opinion → False FS

## A. What Is Audit Risk?

Audit risk is the risk that the auditor may unknowingly fail to appropriately modify the opinion on financial statements that are materially misstated.

1. Audit risk arises because the auditor obtains only reasonable (and not absolute) assurance about whether the financial statements are free of material misstatement.
2. Audit risk should be reduced to an appropriately low level before an opinion on the financial statements is expressed.

## B. What Is Material Misstatement?

A material misstatement is defined as an omission or misstatement of accounting information that, in light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would have been changed or influenced by the omission or misstatement.

1. Misstatements can result from errors, which are unintentional, or fraud, which is intentional. Misstatements include:
   a. Inaccuracies in the collection or processing of data.
   b. Departures from generally accepted accounting principles.
   c. Omissions.
   d. Incorrect estimates or judgments.
   e. Inappropriate selection or application of accounting policies.
2. The auditor should consider what level of misstatement would be material, either alone or when aggregated with other misstatements.
3. Misstatements may be described as factual misstatements, judgmental misstatements, or projected misstatements.
   a. **Factual Misstatements**

      Factual misstatements are misstatements about which there is no doubt.
   b. **Judgmental Misstatements**

      Judgmental misstatements are differences arising from the judgments of management concerning accounting estimates that the auditor considers unreasonable or the selection or application of accounting policies that the auditor considers inappropriate.
   c. **Projected Misstatements**

      Projected misstatements are the auditor's best estimate of misstatements in populations, involving the projection of misstatements identified in audit samples to the entire population from which the samples were drawn.

## C. Audit Risk Model = The risk that the auditor will issue the wrong opinion

1. Audit risk is comprised of the risk that the financial statements are materially misstated (risk of material misstatement, or "RMM") and the risk that the auditor will not detect such misstatements (detection risk, or "DR").

Exists independent
of financial statement
audit



RMM

AR = (IR x CR) x DR

| AR<br>Audit Risk<br>(should be low) | = | RMM<br>Risk of Material Misstatement<br>(assessed by auditor) | × | DR<br>Detection Risk<br>(controlled by auditor) |
|---|---|---|---|---|

2. The components of audit risk may be assessed either quantitatively (e.g., as a percentage), or nonquantitatively (e.g., high, medium, low, etc.).

3. **Risk of Material Misstatement (RMM = IR x CR)**

   a. The auditor makes an assessment of the risks of material misstatement by performing risk assessment procedures and, where appropriate, tests of controls (covered later).

   b. The risk of material misstatement can be subdivided into inherent risk ("IR") and control risk ("CR").

   c. **Inherent Risk ("IR")**

   Client's accounting system has errors (prevent)

   Inherent risk is the susceptibility of a relevant assertion to a material misstatement, assuming there are no related controls.

   (1) Assertions involving high volume transactions, complex calculations, amounts derived from estimates, and cash have relatively higher inherent risk than assertions without those characteristics.

   Note

   Both are the "client" system
   CPA = Assesses

   (2) Other factors specific to the entity and its environment may also tend to increase inherent risk, such as technological developments that render a product obsolete, a lack of working capital, or a decline in the overall industry or economy.

   d. **Control Risk ("CR")**

   Client's internal control does not catch it (detection)

   Control risk is the risk that a material misstatement that could occur in a relevant assertion will not be prevented or detected (and corrected) on a timely basis by the entity's internal control.

   (1) Control risk is a function of the effectiveness of the design and operation of internal control.

   (2) Some amount of control risk will always exist due to inherent limitations of any system of internal control (covered later).

   e. Inherent risk and control risk exist independently of the audit, and the auditor generally cannot change these risks.

**PASS KEY**

While the auditor cannot generally change the risk of material misstatement, the auditor can change his or her **assessment** of this risk as the audit progresses. Many exam questions present a change in the auditor's assessed level of risk and require the candidate to determine the effect of this change.

4. **Detection Risk ("DR")**

   Auditor misses the mistake (error/fraud) & gives wrong opinion

   Detection risk is the risk that the auditor will not detect a material misstatement that exists in a relevant assertion.

   a. Detection risk is a function of the effectiveness of audit procedures and of the manner in which they are applied.

   CPA controls

Less risk
More risk

$\overbrace{IR \times CR}^{RMM}$ DR

Less work = More risk (accepted)
More work = Less risk (accepted)



b. Some amount of detection risk will always exist because the auditor does not typically examine 100 percent of an account balance or transaction class, and because the auditor may make mistakes in applying audit procedures or in interpreting results.

c. Detection risk can be subdivided into tests of details risk ("TD") and substantive analytical procedures risk ("AP").

d. The auditor *can* change detection risk (see below).

e. In a *group audit*, detection risk includes the following risks:

(1) the risk that a component auditor may not detect a misstatement in the financial information of a component that could cause a material misstatement of the group financial statements; and

(2) the risk that the group engagement team may not detect this misstatement.

**5. Effect on the Audit**

The auditor's overall judgment about the level of risk in an engagement will affect the staffing, level of supervision, and scope of the audit. While auditors use professional judgment to assess each aspect of audit risk, they can change only the level of detection risk. The auditor uses his or her assessment of the risks of material misstatement as a basis for determining an appropriate level of detection risk.

**a. Inverse Relationship of RMM to DR**

When the auditor determines that the risk of material misstatement is high, detection risk should be set at a low level. Conversely, when the risk of material misstatement is low, the auditor can justify a higher detection risk.

**b. The Auditor Can Change Detection Risk**

The auditor can change the level of detection risk by varying the nature, extent, and timing of audit procedures. For example, as the acceptable level of detection risk decreases, the assurance provided from substantive procedures should increase. The auditor may:

(1) Change the nature of substantive tests from a less effective to a more effective procedure (e.g., direct test toward independent parties outside the entity rather than toward parties or documentation inside the entity).

(2) Change the extent of substantive tests (e.g., use a larger sample size).

(3) Change the timing of substantive tests (e.g., perform substantive tests at year-end rather than at interim).

Alternatively, if the acceptable level of detection risk increases, the assurance that must be obtained from substantive tests decreases, allowing for somewhat less persuasive evidence to be used, for a reduction in the extent of testing, or for more testing to be performed on an interim basis.

**c. Substantive Procedures Required**

Note that even when the assessed risk of material misstatement is low, substantive procedures will always be necessary for all relevant assertions related to material transaction classes, account balances, and disclosures.

**PASS KEY**

Many exam questions deal with the relationship between the risk of material misstatement (RMM) and detection risk, or between RMM and substantive procedures. While there is an inverse relationship between RMM and detection risk, there is a direct relationship between RMM and the assurance required from substantive procedures. In other words, greater risk requires more persuasive evidence, a larger sample size, and/or a shift from interim to year-end testing.

## II. AUDIT RISK AND MATERIALITY—*Consideration During an Audit*

### A. Overall Considerations

1. Audit risk and materiality should be considered together in designing the nature, extent, and timing of audit procedures and in evaluating the results of those procedures.
2. Considerations of audit risk and materiality are affected by the size and complexity of the entity, as well as the auditor's experience with and knowledge of the entity, its environment, and its internal control.
3. Audit risk and materiality must be considered at both the financial statement level and the account balance, individual transaction class, or disclosure item level.

### B. Considerations at the Financial Statement Level

At the financial statement level, the auditor should consider risks that have a pervasive effect on the financial statements, potentially affecting many relevant assertions. Audit risk at the financial statement level often relates to the entity's control environment.

**1. Purpose**

Considerations of audit risk and materiality at the financial statement level are used to:

a. Design risk assessment procedures.

b. Identify and assess risk.

c. Design further audit procedures.

d. Evaluate the financial statements taken as a whole.

**2. Auditor's Response**

In responding to audit risk at the financial statement level, the auditor should consider:

a. The competency of personnel assigned to the engagement.

b. The potential need for a specialist.

c. The appropriate level of supervision of assistants.

### C. Considerations at the Account Balance, Transaction Class, or Disclosure Item Level

Assertion categories (COVER U)

**1. Purpose**

"NET"

Considerations of audit risk and materiality at the account balance, individual transaction class, or disclosure item level are used to determine the nature, extent, and timing of audit procedures to be applied to specific account balances, transaction classes, or disclosure items. The audit risk model may be useful in this regard.

**2. Inverse Relationship Between Audit Risk and Materiality**

There is an inverse relationship between audit risk and materiality. The risk of a very large misstatement may be low, whereas the risk of a small misstatement may be high. Also, the more material a misstatement is, the less likely it is that the auditor will not detect it.

# FRAUD RISK

## I. WHAT IS FRAUD?

Fraud

### A. Fraud vs. Error

**1. Error** = Unintentional

Errors are unintentional misstatements or omissions of amounts or disclosures in the financial statements. They include mistakes in gathering or processing accounting data, inaccurate accounting estimates, and misunderstanding or unintentional misapplication of accounting principles.

**2. Fraud** = Intentional

Fraud is an intentional act by one or more individuals among management, those charged with governance, employees or third parties, involving the use of deception that results in a misstatement of the financial statements.

### B. Types of Fraud

Frauds can be categorized as either fraudulent financial reporting or misappropriation of assets.

**1. Fraudulent Financial Reporting** = Lying

Fraudulent financial reporting involves intentional misstatements or omissions of amounts or disclosures in the financial statements that are designed to deceive financial statement users. These are usually acts of management and may involve:

a. manipulation, falsification, or alteration of accounting records or supporting documents from which financial statements are prepared;

b. misrepresentation in, or intentional omission from, the financial statements of events, transactions, or other significant information; or

c. intentional misapplication of accounting principles relating to amounts, classification, manner of presentation, or disclosures.

**2. Misappropriation of Assets** = Stealing

Misappropriation of assets, or defalcation, involves theft of an entity's assets when the effect of the theft causes the financial statements not to be presented in conformity with GAAP. These acts usually involve one or more individuals among management, employees, or third parties, and may involve stealing assets or causing an entity to pay for something that has not been received.

3. Corruption = Cheating

### C. Characteristics of Fraud

Fraud Risk Factors

**1. Fraud Risk Factors**

Three conditions generally are present when fraud occurs. These conditions are referred to as "fraud risk factors," and the auditor considers such factors when assessing fraud risk.

a. Incentives/Pressures: a reason to commit fraud.

b. Opportunity: a lack of effective controls.

c. Rationalization/Attitude: an attempt to justify fraudulent behavior.

Ethics & integrity

## II. CONSIDERATION OF FRAUD DURING AN AUDIT

### A. Reasonable Assurance

Due to the concealment aspects of fraud and the need to apply judgment in evaluating fraud risk, even a properly planned and executed audit may fail to detect fraud. In expressing an audit opinion, the auditor provides only reasonable (not absolute) assurance that the financial statements are free of material misstatements resulting from errors or fraud.

Therefore, even a quality audit may not uncover fraud

1. The risk of not detecting a material misstatement resulting from fraud is higher than the risk of not detecting one resulting from error.
2. The risk of not detecting a material misstatement resulting from management fraud is greater than for employee fraud because management is in a position to manipulate accounting records, present fraudulent financial information, or override controls.
3. Fraud is often difficult to detect because those engaged in fraud will generally try to conceal it. Collusion among various parties can also make it difficult to detect fraud.
4. The auditor's ability to detect fraud depends on the skillfulness of the perpetrator, the frequency and extent of manipulation, the degree of collusion involved, the relative size of the individual amounts manipulated, and the seniority of the individuals involved.

### B. Responsibility

#### 1. Management's Responsibility

It is management's responsibility to design and implement programs and controls to prevent, deter, and detect fraud.

#### * 2. Auditor's Responsibility

Design

The auditor has a responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud. As part of audit planning, the auditor must specifically assess the risk of material misstatement of the financial statements due to fraud and should consider this assessment in designing the audit procedures to be performed. This fraud risk assessment is an ongoing process and should be considered in every phase of the audit.

### C. Audit Requirements

#### 1. Professional Skepticism

The auditor should maintain an attitude of professional skepticism which includes a questioning mind and a critical assessment of audit evidence.

a. The auditor should consider that fraud can occur regardless of any past experience with the entity or any belief about management's honesty and integrity.

b. The auditor should not rationalize or dismiss information that may be indicative of fraud.

#### 2. Audit Procedures

The auditor should perform the following procedures:

a. Discuss fraud risk with engagement personnel.

b. Obtain information to identify specific fraud risks.

c. Assess fraud risk and develop an appropriate response.

d. Evaluate audit evidence regarding fraud.

e. Make appropriate communications about fraud.

f. Document the auditor's consideration of fraud.

## D. Required Discussion Among Engagement Personnel

A discussion of the potential for material misstatement due to fraud is required as part of planning.

### 1. Discussion Topics

The discussion should include:

a. "Brainstorming" (an exchange of ideas) regarding:

(1) how and where the financial statements might be susceptible to material misstatement due to fraud;

(2) how management could perpetuate and conceal fraudulent financial reporting; and

(3) how assets could be misappropriated.

**PCAOB STANDARDS—GUIDANCE FOR ISSUERS**

PCAOB standards state that the auditor should consider the susceptibility of the financial statements to material misstatement through related party transactions and how fraud could be perpetrated or concealed by omitting or presenting incomplete or inaccurate disclosures.

b. An emphasis on the importance of professional skepticism.

c. Consideration of factors that create incentives or pressures to commit fraud, that provide an opportunity for fraud to be perpetrated, or that indicate a culture or environment that enables management to rationalize committing fraud.

d. Consideration of the risk of management override of controls.

Fraud environment
- Pressure
- Opportunity
- Rationalization

e. How the auditor might respond to identified fraud risks.

### 2. Other Requirements

The discussions should involve all key members of the audit team including the engagement partner, may include specialists, and may occur in multiple locations. Communication should continue throughout the audit.

**U.S. AUDITING STANDARDS VS. INTERNATIONAL STANDARDS ON AUDITING**

ISAs do not include the required brainstorming session, the participation of key engagement team members and the engagement partner, or communication throughout the audit among engagement team members.

## E. Obtaining Information

The auditor should perform the following procedures to obtain information useful in identifying potential fraud risks.

### 1. Inquire of Entity Personnel Regarding Their Views of Fraud Risk

a. The auditor should direct inquiries to management, employees involved in financial reporting, operating personnel, internal auditors, in-house legal counsel, those charged with governance, etc.

b. Inquiries should be made regarding:

(1) The overall risk of fraud.

(2) Identified or suspected instances of fraud.

(3) The process for identifying and responding to fraud risk and controls established to address fraud risk.

(4) The extent of oversight of distant locations and whether there are particular locations or business segments for which a fraud risk might be more likely to exist.

(5) Communication of management's code of ethics.

(6) Whether management has reported to those charged with governance regarding internal control and how it functions to prevent, deter, or detect material misstatement due to fraud.

(7) What type of oversight the audit committee provides.

c. Inconsistent responses or responses that are otherwise unsatisfactory (e.g., vague or implausible responses) indicate a need for additional evidence.

**U.S. AUDITING STANDARDS VS. INTERNATIONAL STANDARDS ON AUDITING**

ISAs do not require the auditor to investigate responses that are otherwise unsatisfactory.

**PCAOB STANDARDS—GUIDANCE FOR ISSUERS**

PCAOB standards state that the auditor should ask management and the audit committee whether they have received and responded to tips or complaints regarding the company's financial reporting. PCAOB standards also state that the auditor should ask the internal auditors regarding procedures performed to identify or detect fraud and whether management responded appropriately to any findings from those procedures. In addition, the auditor should ask management, the audit committee, and the internal auditors whether the company has entered into any significant, unusual transactions.

2. **Consider the Results of Analytical Procedures**: required during < Planning stage / Final review stage

The auditor is required to perform analytical procedures in planning the audit, and should consider the implications of any unusual or unexpected relationships identified.

a. During planning, the auditor is specifically required to perform analytical procedures relating to revenue, in order to identify unusual relationships that might be indicative of fraud.

**U.S. AUDITING STANDARDS VS. INTERNATIONAL STANDARDS ON AUDITING**

ISAs do not specifically require analytical procedures relating to revenue.

b. Analytical procedures performed during planning often use data aggregated at a high level, and therefore such procedures may provide only a broad indication regarding fraud risk.

3. **Evaluate Fraud Risk Factors**

As discussed previously, three conditions (incentives/pressures, opportunity, and rationalization/attitude) generally are present when fraud occurs. The auditor should use professional judgment to determine whether and to what extent such conditions are present.

a. **Existence of Risk Factors**

While the risk of material misstatement due to fraud is greatest when all three risk factors are present, the existence of all three fraud risk factors is not an absolute indication that fraud has occurred.

b. **Absence of Risk Factors**

Lack of observation of any or all of the three fraud risk factors does not imply that there is no fraud risk. One condition may be significant enough on its own to cause a risk of material misstatement due to fraud.

## F. Identifying Risks

The auditor should use the information gathered to identify risks that may result in a material misstatement (at either the financial statement or relevant assertion level) due to fraud.

### 1. Attributes of Risk

In analyzing risk, the following four attributes should be considered.

a. Type of risk: Does it involve fraudulent financial reporting or misappropriation of assets? Or corruption

b. Significance of the risk: Can it lead to a *material* misstatement?

c. Likelihood of the risk: How likely is this to happen?

d. Pervasiveness of the risk: Does it affect the financial statements as a whole or only specific accounts, transactions, or assertions?

### 2. Presumption of Risk

There is a presumption in every audit that the following two risks exist:

a. Improper revenue recognition : analytical procedures required

b. Management override of controls

These risks should be addressed by the auditor in evaluating the overall fraud risk.

### 3. Additional Considerations

The auditor should also consider the following factors.

a. Whether and to what extent the three fraud risk factors are present.

b. The size, complexity, and ownership characteristics of the entity.

(1) Large entities may have an audit committee, an internal audit function, or a formal code of conduct, all of which may serve to deter fraud.

(2) A smaller entity may lack such features; however, it may exhibit a strong corporate culture that discourages fraud.

c. The susceptibility of items to manipulation. Items are more susceptible to manipulation when they involve:

(1) a high degree of management judgment and subjectivity; or

(2) highly complex accounting principles.

Greater risk

**PCAOB STANDARDS—GUIDANCE FOR ISSUERS**

PCAOB standards state that the auditor's evaluation of fraud risk factors should include an evaluation of how fraud can be perpetrated or concealed by presenting incomplete or inaccurate disclosures, or by omitting required disclosures.

## G. Assessing Risks

The auditor evaluates the identified fraud risks after considering the effect of the entity's programs and controls.

1. The auditor is required to obtain an understanding of the entity and its environment, including its internal control, as part of planning the audit.
2. Specific controls may mitigate specific risks; broader controls (such as those promoting a culture of honesty) may mitigate overall risk.
3. An identified control deficiency may increase the fraud risk assessment.

**H. Responding to Assessed Fraud Risk**

**1. Required Response**

The auditor is required to respond to the results of the fraud risk assessment on three levels.

1 of 3 **a. Overall, General Response**

The auditor should consider the overall fraud risk when:

(1) Assigning personnel to the engagement.

(2) Determining the appropriate level of supervision of engagement personnel.

(3) Evaluating management's selection and application of accounting principles.

(4) Incorporating an appropriate level of unpredictability in the selection of auditing procedures from one year to the next. The auditor should incorporate an element of unpredictability into every audit.

2 of 3 **b. Response Encompassing Specific Audit Procedures** = "NET"

The auditor should respond to specifically identified fraud risks by altering the nature, extent, or timing of audit procedures. While the auditor's response may include both substantive tests and tests of controls, tests of controls alone generally are insufficient due to the risk of management override.

3 of 3 **c. Response Addressing Risks Related to Management Override**

The following procedures should be performed to address the risk of management override of controls.

(1) Examine journal entries and other adjustments for evidence of possible material misstatement due to fraud. For example, the auditor might focus on nonstandard or unusual entries.

(2) Review accounting estimates for biases that could result in material misstatement due to fraud. The auditor should also perform a retrospective review (comparing prior period estimates to actual subsequent events) to provide insight regarding management bias.

(3) Evaluate the business purpose for significant unusual transactions. For instance, the auditor might consider transactions that are overly complex or those where the accounting does not reflect the underlying substance of the transaction.

**2. Significant Risks** → Withdraw

The auditor should treat the assessed risks of material misstatement due to fraud as significant risks and should obtain an understanding of the entity's related controls, including whether the controls have been suitably designed and implemented to mitigate fraud risks.

## I. Evaluating Audit Evidence

The auditor is required to assess fraud risk throughout the audit and to evaluate, at the completion of the audit, whether accumulated audit results affect this assessment.

### 1. Conditions Identified During Fieldwork

Certain conditions noted during fieldwork may affect the auditor's assessment of fraud risk. While such conditions suggest the possibility of fraud, they are not absolute evidence that fraud has occurred.

a. Discrepancies in the accounting records.

b. Conflicting or missing evidential matter.

c. Problematic relationships between the auditor and management.

d. Objections by management to the auditor meeting privately with the audit committee.

e. Accounting policies that appear inconsistent with industry practices that are widely recognized and prevalent.

f. Frequent changes in accounting estimates that do not appear to result from changing circumstances.

g. Tolerance of violations of the company's code of conduct.

### 2. Analytical Procedures : required during < Planning stage / Final review stage

The results of analytical procedures performed by the auditor during or at the completion of the audit may indicate a fraud risk that was not previously identified. The auditor should pay careful attention to unusual relationships relating to year-end revenue and income.

### 3. Misstatements Due to Fraud

The auditor should consider whether any misstatements identified during the audit are indicative of fraud, and should evaluate the related implications.

a. Misstatement caused by fraud (even immaterial misstatements) may be indicative of an underlying problem with management integrity. → Fraud

b. The auditor may need to reevaluate the assessment of fraud risk, the assessed effectiveness of controls, and the appropriateness of the audit procedures applied.

→ Withdraw

### 4. Final Evaluation

A final evaluation (at or near the completion of fieldwork) should be made regarding the assessment of the risks of material misstatement due to fraud. Such evaluation should include communication among engagement personnel and may indicate the need to perform additional audit procedures. In situations where significant risk of material misstatement due to fraud remains, the auditor should consider withdrawing from the engagement.

Pressure
Opportunity
Rationalization

## J. Communications

### 1. Management and Those Charged with Governance

Generally, any indication of fraud (even immaterial fraud) should be discussed with an appropriate level of management at least one level above those involved.

a. Fraud that causes a material misstatement of the financial statements should be discussed with senior management and reported directly to those charged with governance.

b. Any fraud involving senior management, regardless of the impact to the financial statements, should be reported directly to those charged with governance.

c. The auditor should consider whether any identified risk factors represent significant deficiencies or material weaknesses relating to the entity's internal control. Such items should be communicated to senior management and those charged with governance (discussed further in Auditing 5).

d. The auditor may also choose to discuss identified fraud risks in other communications to those charged with governance.

**2. Parties Outside the Entity** → The CPA must communicate with

Ordinarily, the disclosure of fraud to parties outside of senior management and those charged with governance is not part of the auditor's responsibility. However, in certain circumstances, a duty to disclose outside the entity may exist:

CPA must communicate

a. to comply with certain legal and regulatory requirements, such as on Form 8-K and on reports required by the Private Securities Litigation Reform Act of 1995;

b. to a successor auditor when the successor makes inquiries of the predecessor auditor, with specific permission of the client;

c. in response to a subpoena;

d. to a funding agency or other specified agency in accordance with requirements for the auditors of entities that receive governmental financial assistance; and A-5

e. in some circumstances, to authorities when management and those charged with governance fail to take corrective action.

## K. Documentation Requirements

Complete documentation of the auditor's risk assessment and response is required. The auditor should document the following items.

1. The planning discussion among engagement personnel regarding fraud risk, including how and when the discussion occurred, the participants, and the subject matter discussed.

| U.S. AUDITING STANDARDS VS. INTERNATIONAL STANDARDS ON AUDITING |
| --- |
| ISAs do not require documentation of when the discussion occurred or the audit team members who participated. |

2. The procedures performed to obtain information related to fraud risk.
3. Specific identified risks of material misstatement due to fraud.
4. If the auditor has not identified improper revenue recognition as a fraud risk, support for this conclusion.
5. The results of procedures performed to address the risk of management override of controls.
6. Other conditions and analytical relationships that warranted further audit work.
7. The nature of communications made about fraud.

## L. Sarbanes-Oxley Act

Under the Sarbanes-Oxley Act, severe penalties apply to those who destroy records (or willfully fail to maintain them for at least seven years), commit securities fraud, or fail to report fraud. The statute of limitations for the discovery of fraud has also been extended by this Act, and protections have been provided for corporate "whistle-blowers."

# COMPLIANCE WITH LAWS AND REGULATIONS

Corruption = Cheating

## I. EFFECTS OF LAWS AND REGULATIONS

The effects of laws and regulations on financial statements vary considerably. Some laws and regulations have a direct effect on the financial statements because they determine the amounts reported and the disclosures in the financial statements. Other laws and regulations do not have a direct effect on the financial statements.

### A. Noncompliance

Noncompliance is an act of omission or commission by an entity, whether intentional or unintentional, which is contrary to prevailing laws and regulations. Such acts may be committed by, or in the name of, the entity or on its behalf by those charged with governance, management, or employees. Noncompliance does not include personal misconduct unrelated to the business activities of the entity.

Noncompliance with laws and regulations can result in fines, litigation, or other consequences to the entity that may have a material effect on the financial statements.

## II. RESPONSIBILITY FOR COMPLIANCE WITH LAWS AND REGULATIONS

### A. Management's Responsibility

Management and those charged with governance are responsible for ensuring that the entity's operations are conducted in accordance with applicable laws and regulations, including laws and regulations that determine the reported amounts and disclosures in the financial statements.

### B. Auditor's Responsibility

The auditor is responsible for obtaining reasonable assurance that the financial statements are free of material misstatement due to noncompliance with laws and regulations. However, the auditor is not responsible for preventing noncompliance and cannot be expected to detect noncompliance with all laws and regulations. The further removed noncompliance is from the financial statements, the less likely the auditor is to recognize the noncompliance.

#### 1. Inherent Limitations

The potential effects of inherent limitations on an auditor's ability to detect material misstatements are greater for material misstatements due to laws and regulations because:

a. Many laws and regulations relating to an entity's operations do not affect the financial statements and are not captured by informations systems relevant to financial reporting.

b. Noncompliance may be concealed by collusion, forgery, deliberate failure to record transactions, management override of controls, or intentional misrepresentations to the auditor.

c. Whether an act constitutes noncompliance is a matter for legal determination.

## III. AUDITOR PROCEDURES RELATED TO NONCOMPLIANCE : get signed management rep. letter

### A. The Auditor's Consideration of Noncompliance

1. When obtaining an understanding of the entity and its environment, the auditor should obtain an understanding of:

   a. the legal and regulatory framework applicable to the entity and the industry or sector in which it operates; and

   b. how the entity is complying with that framework.

2. The auditor should obtain sufficient appropriate audit evidence regarding material amounts and disclosures in the financial statements that are determined by the provisions of laws and regulations that have a *direct effect* on the financial statements.

3. For the provisions of laws and regulations that have an *indirect effect* on the financial statements but have a fundamental effect on the entity's operations, the auditor should perform the following procedures to identify instances of noncompliance that may have a material effect on the financial statements:

   a. Inquire of management and those charged with governance about whether the entity is in compliance with such laws and regulations.

   b. Inspect correspondence with relevant licensing and regulatory authorities.

4. The auditor should consider the evidence gathered in other audit procedures that may reveal instances of noncompliance or suspected noncompliance.

### B. Procedures When Noncompliance is Identified or Suspected

If the auditor suspects that noncompliance may exist, the auditor should discuss the matter with management at least one level above those suspected of noncompliance and, when appropriate, those charged with governance. If management or those charged with governance cannot provide sufficient information that shows that the entity is in compliance with laws and regulations and the effects of the noncompliance may be material, the auditor may consider it necessary to consult with the entity's in-house or external legal counsel or with the auditor's own legal counsel. The auditor may also withdraw from the engagement, if withdrawal is possible under applicable law or regulation.

## IV. REPORTING NONCOMPLIANCE

### A. Reporting to Those Charged With Governance

If those charged with governance are not involved in management of the entity, the auditor should communicate with those charged with governance matters involving noncompliance, other than matters that are clearly inconsequential. If the noncompliance appears to be intentional and material, the auditor should communicate the matter to those charged with governance as soon as practicable.

If management or those charged with governance are involved in noncompliance, the auditor should communicate the matter to the next higher level of authority at the entity. If there is no higher level of authority, the auditor may need to obtain legal advice.

**B. Reporting to Regulatory and Enforcement Authorities**

Ordinarily, the disclosure of noncompliance to parties other than management and those charged with governance is not part of the auditor's responsibility because of the auditor's professional duty of confidentiality. In the following circumstances, a duty to disclose outside the entity may exist:

1. In response to inquiries from an auditor to a predecessor auditor.
2. In response to a court order.
3. In compliance with requirements for the audits of entities that receive federal financial assistance from a government agency.

**C. Reporting Noncompliance in the Auditor's Report**

**1. Material Effect on the Financial Statements** GAAP issue = Except for or adverse

If the noncompliance has a material effect on the financial statements and has not been adequately reflected in the financial statements, a qualified opinion or adverse opinion should be issued.

**2. Insufficient Evidence** GAAS issue = Except for or disclaimer

If the auditor is unable to obtain sufficient appropriate audit evidence about the noncompliance or suspected noncompliance, a qualified opinion or a disclaimer of opinion should be expressed.

**3. Client Response** /refuse = GAAS issue = Withdrawal issue

If the client refuses to accept the auditor's report as modified, the auditor should withdraw from the engagement and notify those charged with governance in writing.

# ASSESSING THE RISKS OF MATERIAL MISSTATEMENT

| |
|---|
| **I**nternal control, entity, and environment—obtain an understanding |
| **M**aterial misstatement—assess the risk |
| **A**ssessed level of risk response |
| **C**ontrol testing |
| **P**erform substantive testing |
| **A**udit evidence—evaluate appropriateness & sufficiency |

## I. INTRODUCTION

### A. Purpose

An understanding of the entity and its environment enables the auditor to:

1. Identify and assess the risks of material misstatement.
2. Make informed judgments about other audit matters, including:
   a. Materiality and tolerable misstatement.
   b. The entity's selection and application of accounting procedures.
   c. Areas that require special audit consideration.
   d. The development of expectations for analytical procedures.
   e. The design and performance of further audit procedures.
   f. The evaluation of audit evidence.

### B. Assessing the Risks of Material Misstatement

The auditor performs a series of steps in assessing the risks of material misstatement and responding appropriately to that risk.

I 1. Obtain an understanding of the entity and its environment, including its internal control.

M 2. Assess the risks of material misstatement. = ID types of potential misstatement

A 3. Respond to the assessed level of risk by designing further audit procedures based on this assessment.

C 4. Test internal controls to evaluate their operating effectiveness.

P 5. Perform substantive procedures.

A 6. Evaluate the sufficiency and appropriateness of audit evidence obtained.

**PASS KEY**

The risk of material misstatement (RMM) is a function of inherent risk (IR) and control risk (CR). The process of obtaining an understanding of the entity and its environment, including its internal control, is the process of assessing the entity's inherent risk and control risk. Once inherent risk and control risk have been assessed, the auditor determines the overall risk of material misstatement and the acceptable level of detection risk. The acceptable level of detection risk is used to determine the nature, extent, and timing of further audit procedures (tests of controls and substantive procedures).

## II. OBTAINING AN UNDERSTANDING OF THE ENTITY AND ITS ENVIRONMENT

| |
|---|
| **I**nternal control, entity, and environment—obtain an understanding |
| **M**aterial misstatement—assess the risk |
| **A**ssessed level of risk response |
| **C**ontrol testing |
| **P**erform substantive testing |
| **A**udit evidence—evaluate appropriateness & sufficiency |

Obtaining an Understanding of the Entity and its Environment

Obtaining an understanding of the entity and its environment is critical, as it establishes a frame of reference for planning and performing the audit. While the extent of this understanding is left to the auditor's professional judgment, it must be sufficient both to assess the risk of material misstatement and to design and perform further audit procedures.

### A. Risk Assessment Procedures

Risk Assessment Procedures

The auditor should use the following risk assessment procedures to obtain an understanding of the entity and its environment, including its internal control.

1. **Inquiries**
   a. Inquiries are generally made of management and others within the entity.
   b. Inquiries may also be made of other parties, including the board of directors and audit committee, internal auditors, and parties outside the entity (external legal counsel, valuation experts, etc.).

2. **Analytical Procedures** : required during < Planning stage / Final review stage

Analytical Procedures

Analytical procedures are evaluations of financial information made by a study of plausible relationships among both financial and nonfinancial data.

a. **Use of Analytical Procedures**

Analytical procedures are used:

Required

(1) during planning to understand the entity and identify areas of risk (mandatory);

(2) as substantive tests to obtain audit evidence (optional); and

(3) as an overall review in the final review stage of the audit (mandatory).

Substantive test

b. **Analytical Procedures Performed During Planning**

GAAS requires

(1) During planning, analytical procedures consist of a review of data aggregated at a high level, such as comparing financial statements to budgeted or anticipated results.

(2) Generally, financial data is used, though relevant nonfinancial data (e.g., number of employees, square footage of selling space, or volume of goods produced) and their relationships with related financial data may also be considered.

(3) The objective of analytical procedures used during planning is to:

(a) Enhance the auditor's understanding of the entity and of transactions and events that have occurred since the last audit date.

(b) Identify unusual transactions and events, and amounts, ratios, or trends that might be significant to the financial statements and may represent specific risks relevant to the audit.

**PCAOB STANDARDS—GUIDANCE FOR ISSUERS**

Presumptive risk area

PCAOB standards state that when applying analytical procedures as risk assessment procedures, the auditor should perform analytical procedures related to revenue in order to identify unusual or unexpected relationships that might indicate material misstatement, including material misstatement due to fraud. The auditor should also take into account analytical procedures performed during interim reviews.

3. **Observation and Inspection**

The auditor may observe activities and operations, inspect company documents, read management reports, board minutes, and internal audit reports, visit the entity's premises, and trace transactions through the information system.

4. **Risk Assessment Discussion** → With audit team

The members of the audit team, including the auditor with final responsibility for the audit, other key members of the audit team, and specialists (as necessary), should discuss the susceptibility of the financial statements to material misstatement. This discussion:

a. Can be held concurrently with the fraud risk discussion.

b. Should include areas of significant audit risk, areas susceptible to management override of controls, application of GAAP to the specific facts and circumstances surrounding the entity, areas involving unusual accounting procedures, important control systems, and materiality levels.

c. Allows more experienced team members to share their insights with less experienced staff.

d. Should emphasize the need to exercise professional skepticism, and to be alert for and rigorously investigate any potential misstatements.

e. Should continue throughout the audit, including when conditions change.

**PCAOB STANDARDS—GUIDANCE FOR ISSUERS**

PCAOB standards state that the key engagement team members should discuss:

1. the company's selection and application of accounting principles, including disclosure requirements; and
2. the susceptibility to the company's financial statements to misstatement, whether due to error or fraud.

If the audit involves multiple locations, then there can be multiple discussions. Important matters should be communicated to all engagement members not present for the discussion(s).

5. **Other Procedures**

In obtaining an understanding of the entity and its environment, the auditor should also consider:

a. Reviewing external information (e.g., trade journals, analysts' reports, etc.).

b. The results of the fraud risk assessment.

c. Information obtained during the client acceptance or continuance process.

d. Information obtained on other engagements performed for the entity.

e. Prior period evidence, to the extent that it is still relevant.

**PCAOB STANDARDS—GUIDANCE FOR ISSUERS**

PCAOB standards state that the auditor should perform the following risk assessment procedures:

- obtain an understanding of the company and its environment;
- obtain an understanding of internal control over financial reporting;
- consider information relevant to identifying risks of material misstatement from the client acceptance and retention evaluation, audit planning activities, past audits, interim reviews, and other engagements performed by the company;
- perform analytical procedures;
- conduct a discussion among engagement team members regarding the risks of material misstatement; and
- inquire of the audit committee, management, and others within the company about the risks of material misstatement.

## B. Risk Assessment Procedures and Audit Evidence : always necessary in FS audit

1. Risk assessment procedures sometimes provide audit evidence about transactions, balances, disclosures, or controls, even if they were not designed to provide such evidence.
2. The auditor may also choose to perform substantive procedures or tests of controls concurrently with risk assessment procedures, if it is efficient to do so.

## C. Ongoing Assessment

Obtaining an understanding of the entity and its environment is a process that continues and evolves throughout the audit, and the auditor's assessment of risk may change as additional audit evidence is obtained. For example, the initial risk assessment may presume effective operation of controls, but:

1. tests of controls may indicate that controls are not operating effectively; or
2. the auditor may detect more or less frequent misstatements than would have been expected given the initial risk assessment.

In such situations, the auditor should revise the assessment and modify planned audit procedures.

## D. Factors to Understand the Entity and Environment

The auditor should obtain an understanding of the following factors, and should also consider whether any of the factors have changed significantly as compared to the prior period.

### 1. Industry, Regulatory, and Other External Factors

The auditor should understand the condition of the entity's industry, the regulatory environment in which the entity operates, and the general economic conditions that impact the entity.

### 2. Nature of the Entity

The auditor's understanding of the nature of the entity should include an understanding of the entity's operations, ownership, corporate governance, investments, financing methods, and financial reporting practices.

- Analytical procedures ] Required
- Risk assessment procedures ]

- Test of operating effectiveness of controls = Not required

**PCAOB STANDARDS—GUIDANCE FOR ISSUERS**

PCAOB standards state that the auditor should consider performing the following procedures to obtain an understanding of the nature of the entity:

- Read public information about the entity relevant to the evaluation of the likelihood of material financial statement misstatement and the effectiveness of the entity's internal control over financial reporting;
- Observe or read transcripts of earnings calls and other publicly available meetings with investors and ratings agencies;
- Obtain an understanding of compensation arrangements with senior management, including incentive compensation arrangements, changes or adjustments to those arrangements, and special bonuses;
- Obtain information from SEC filings and other sources about trading activity in the entity's securities and holdings of significant shareholders;
- Inquire of the chair of the compensation committee (or its equivalent), and any compensation consultants engaged by either the compensation committee or the company, regarding the structuring of the company's compensation for executive officers; and
- Obtain an understanding of the company's established policies and procedures regarding the authorization and approval of executive officer expense reimbursement.

### 3. Selection and Application of Accounting Policies

The auditor should understand the entity's selection and application of accounting policies, including the reasons for changes. The auditor should evaluate whether the accounting policies are appropriate for the entity's business and consistent with the applicable financial reporting framework and the industry in which the entity operates.

### 4. Objectives, Strategies, and Business Risks

An entity's objectives are the overall plans for an entity. Its strategies are the means used to achieve objectives. Business risks result from events or circumstances that could adversely affect the entity's ability to achieve its objectives and execute its strategies.

### 5. Entity's Financial Performance

Management measures and reviews the entity's financial performance to evaluate whether business performance is meeting the desired objectives. The auditor should obtain an understanding of this measurement and review, as it may indicate a risk of misstatement. For example, in situations where management receives performance-based compensation, unusual growth or profitability may be indicative of management bias in the financial statements.

**PCAOB STANDARDS—GUIDANCE FOR ISSUERS**

The PCAOB lists the following examples of performance measures that might affect the risk of material misstatement:

- measures that form the basis for contractual commitments or incentive compensation arrangements;
- measures used by external parties, such as analysts and rating agencies, to review a company's financial performance; and
- measures that the company uses to monitor operations.

The first two measures listed may create incentives and pressures to commit fraud. The third measure may be used by management to monitor risks affecting the financial statements.

### 6. Internal Control, Including the Selection and Application of Accounting Policies

The auditor should obtain an understanding of internal control relevant to the audit. Internal control is a process—affected by those charged with governance, management, and other personnel—designed to provide reasonable assurance about the achievement of the entity's objectives.

| PASS KEY |
|---|
| The auditor's understanding of the entity's internal control allows the auditor to make a preliminary assessment of the entity's control risk (CR). The auditor's understanding of industry, regulatory, and other factors, the nature of the entity, the entity's objectives strategies, and business risks, and the entity's financial performance aid the auditor in assessing the entity's inherent risk (IR). |

### E. Understanding the Group, Its Components, and Their Environment

When obtaining an understanding of the entity and its environment in a group audit, the group engagement team should do the following:

1. Enhance its understanding of the group, its components and their environments, including group-wide controls.
2. Obtain an understanding of the consolidation process, including the instructions issued by group management to components.
3. Confirm or revise its initial identification of significant components.

## III. ASSESSING THE RISKS OF MATERIAL MISSTATEMENT

| |
|---|
| **I**nternal control, entity, and environment—obtain an understanding |
| **M**aterial misstatement—assess the risk |
| **A**ssessed level of risk response |
| **C**ontrol testing |
| **P**erform substantive testing |
| **A**udit evidence—evaluate appropriateness & sufficiency |

The auditor uses the understanding of the entity and its environment, including its internal controls, to assess the risks of material misstatement at the financial statement level and at the relevant assertion level and to identify any significant risks.

### A. Scope of the Assessment

The assessment of the risks of material misstatement includes the assessment of the entity's inherent risk and control risk. The auditor can:

1. Separately assess inherent risk and control risk and then combine these risk assessments to determine an overall risk of material misstatement.
2. Make a single overall assessment of the risks of material misstatement.

### B. Assessing Specific Risks

For each identified risk, the auditor should consider:

1. What could go wrong at the relevant assertion level.
2. The significance and likelihood of potential material misstatements.
3. Whether the risk is significant enough to require special audit consideration (see "significant risks," covered below).
4. Whether tests of controls are required because substantive tests alone are insufficient to reduce detection risk to an acceptably low level.
5. Whether the risk relates to a specific relevant assertion or whether it has a more pervasive effect on the financial statements.

#### a. Assertion Level Risks

"COVER U"

Assertion level risks are risks that relate to specific transactions, account balances, or disclosures at the relevant assertion level. When assessing the risk of material misstatement at the assertion level, the auditor should identify controls that have been properly designed and implemented such that the controls are capable of effectively preventing or detecting and correcting material misstatements that could arise from the risks.

**PCAOB STANDARDS—GUIDANCE FOR ISSUERS**

PCAOB standards state that the auditor should identify significant accounts and disclosures and their relevant assertions when assessing the risk of material misstatement. The determination of significant accounts and disclosures and their relevant assertions is made based on inherent risk, without regard for the effect of controls. The auditor should evaluate both qualitative and quantitative risk factors. When a company has multiple locations and business units, the auditor should identify significant accounts and disclosures and their relevant assertions based on the consolidated financial statements. Significant accounts and disclosures and their relevant assertions are the same in the audit of internal control over financial reporting and the audit of the financial statements.

**b. Financial Statement Level Risks**

Financial statement level risks are risks that relate pervasively to the financial statements as a whole and potentially impact many relevant assertions. Financial statement level risks include weaknesses related to:

(1) The process used to prepare the financial statements, including the development of significant accounting estimates and the preparation of financial statement footnotes.

(2) The overall control environment.

(3) Lack of qualified personnel in financial reporting roles.

(4) The selection and application of significant accounting policies.

**PCAOB STANDARDS—GUIDANCE FOR ISSUERS**

PCAOB standards state that the risk of material misstatement at the financial statement level may be especially relevant to the auditor's consideration of the risk of material misstatement due to fraud.

## C. Significant Risks

**Significant Risks**

Significant risks are risks that require special audit consideration. The auditor uses professional judgment to determine if a given risk of material misstatement is a significant risk. The auditor's judgment should be based on the nature of the risk and the magnitude and likelihood of the potential misstatement.

**PASS KEY**

The determination of whether a risk is a significant risk should ignore the effects of controls related to the risk and should be based entirely on inherent risk. A significant risk exists when inherent risk is exceptionally high.

### 1. Factors That May Be Indicative of Significant Risks

a. Risk of fraud

b. Significant recent economic, accounting, or other developments

c. Related parties and related party transactions

d. Improper revenue recognition

e. Nonroutine, unusual, or complex transactions

f. Accounting estimates or other subjective measurements of financial information

g. Noncompliance with laws and regulations

h. Accounting principles that are subject to different interpretations

## D. Other Matters Noted

In assessing the risks of material misstatement, the auditor may note:

1. Significant control-related matters that should be communicated to those charged with governance.
2. Internal control matters, situations that reflect on management integrity, or insufficient entity records, each of which may affect the auditability of the entity. In such cases, the auditor may need to consider qualifying the opinion, disclaiming an opinion, or withdrawing from the engagement.

## E. Required Documentation

The auditor should document:

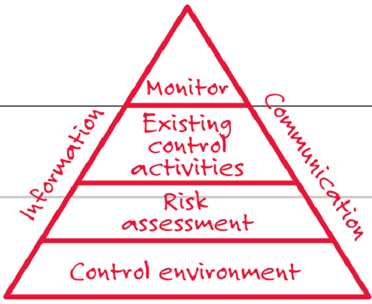
1. The discussion among the audit team, including how and when it occurred, the participants, the subject matter discussed, and significant decisions reached.
2. Key elements of the understanding of the entity and its environment (including each of the components of internal control), the sources of information used to develop the understanding, and the risk assessment procedures performed.
3. The assessment of the risks of material misstatement (at both the financial statement and relevant assertion level) and the basis for the assessment.
4. The identified risks and related controls evaluated by the auditor.
5. A more complex entity/environment results in more extensive audit procedures, which in turn should result in more extensive audit documentation.

**PCAOB STANDARDS—GUIDANCE FOR ISSUERS**

PCAOB standards require that in an audit of the financial statements of a company with operations in multiple locations or business units, the auditor should determine the extent to which audit procedures should be performed at selected locations or business units. The amount of audit attention devoted to a location or business unit should be correlated with the assessment of the risk of material misstatement associated with that location or business unit.

Factors that are relevant to the assessment of the risks of material misstatement associated with a particular location or business unit and the determination of the necessary audit procedures include:

- the nature and amount of assets, liabilities, and transactions executed at the location or business unit, including any significant transactions that are outside the normal course of business for the company or that otherwise appear to be unusual due to their timing, size, or nature ("significant unusual transactions");
- the materiality of the location or business unit;
- the specific risks associated with the location or business unit that present a reasonable possibility of material misstatement to the company's consolidated financial statements;
- whether the risks of material misstatement associated with the location or business unit apply to other locations or business units such that, in combination, they present a reasonable possibility of material misstatement to the company's consolidated financial statements;
- the degree of centralization of records or information processing;
- the effectiveness of the control environment, particularly with respect to management's control over the exercise of authority delegated to others and its ability to effectively supervise activities at the location or business unit; and
- the frequency, timing, and scope of monitoring activities by the company, or others at the location or business unit.




## I. INTERNAL CONTROL

**Internal Control**

Internal control is a process—effected by those charged with governance, management, and other personnel—designed to provide reasonable assurance about the achievement of the entity's objectives.

### A. Entity Objectives

Objectives represent what an entity strives to achieve. An entity's objectives may be divided into three categories:

Most relevant to audit

1. Reliability of financial reporting. = Financial statement fraud (lying)
2. Effectiveness and efficiency of operations. = Asset misappropriation (stealing)
3. Compliance with applicable laws and regulations. = Corruption (cheating)

**PASS KEY**

The reliability of financial reporting objective is most relevant to the audit. Controls relating to the operations and compliance objectives may occasionally be relevant to the audit, for example, if they relate to nonfinancial data used in analytical procedures, or if they relate to noncompliance with laws or regulations that have a direct and material effect on the financial statements.

### B. Components of Internal Control

**Components of Internal Control**

1. **Five Components of Internal Control**

The COSO framework for internal control consists of five interrelated components. The components represent means used by an entity to help it achieve its objectives.

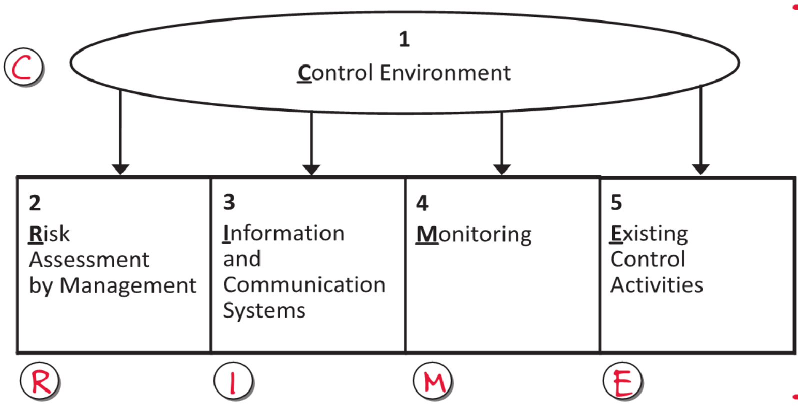
C a. **C**ontrol Environment: the overall tone of the organization.

R b. **R**isk Assessment: management's identification of risk.

I c. **I**nformation and Communication Systems: a means of recording transactions and communicating responsibilities.

M d. **M**onitoring: assessment of internal control performance over time.

E e. **E**xisting Control Activities: control policies and procedures




CPA is required to understand each element of "CRIME" as it relates to financial reporting

It's a "CRIME" not to have a strong internal control

**PASS KEY**

The examiners' questions focus on the control environment and on an entity's existing control activities.

C **2. Control Environment** = Auditor/CPA should obtain understanding & knowledge

a. The control environment:

(1) Sets the tone of an organization, influencing the control consciousness of its employees.

(2) Provides discipline and structure as the foundation for all other components of internal control.

(3) Originates with, and is generated by, management and those charged with governance.

b. The control environment includes such factors as:

(1) Communication and enforcement of integrity and ethical values of the people who create, administer, and monitor internal controls. The control environment is affected by the collective effect of control environment factors, such as written policy statements and codes of conduct, management's actions to reduce occurrence of unethical acts, and management's reaction to violations.

(2) Commitment to competence as reflected in management's consideration of the knowledge and skills required for particular jobs.

(3) Participation of those charged with governance, including an assessment of their knowledge, experience, stature, and independence from management, the extent of their scrutiny of activities and willingness to raise difficult questions, and their interaction with internal and external auditors.

(4) Management's philosophy and operating style, particularly with respect to its approach to risk-taking, its attitudes and actions toward financial reporting, and its attitudes toward information processing, accounting functions, and personnel.

**PASS KEY**

The following circumstances would raise concerns regarding management's philosophy and operating style:

A. Management consumed with meeting the budget. = Pressure

B. Management dominated by one person. = Opportunity (mgt. override)

C. Management compensation contingent upon the entity's financial performance. = Bonus & stock = Rationalize

(5) Organizational structure, which is the framework within which the entity plans, executes, controls, and monitors its activities, including establishment of key areas of authority and responsibility and lines of reporting.

(6) Assignment of authority, responsibility, and accountability.

(7) Human resource policies and practices related to recruitment, orientation, training, evaluating, counseling, promoting, compensating, and remedial activities.

c. The auditor's focus must be on the substance of the control environment rather than the form, because appropriate procedures may be established but not enforced.

d. **Those Charged with Governance**

The auditor should understand the attitudes, awareness, and actions of those charged with governance, with respect to internal control. The responsibilities of those charged with governance include:

(1) Overseeing the financial reporting and disclosure process.

(2) Balancing the conflicting pressures that may be placed on management (i.e., fair financial reporting vs. positive operating results).

(3) Bearing responsibility, together with management, for the prevention and detection of error and fraud.

(4) Overseeing "whistle-blower" procedures.

(5) Overseeing the process for reviewing the effectiveness of the entity's internal control.

e. **Pervasive Effect of Control Environment**

The control environment has a pervasive effect on the auditor's risk assessment, and preliminary judgments about its effectiveness may influence the nature, extent, and timing of further audit procedures to be performed.

"NET"

(1) **Weak Control Environment**

When there is a weak control environment, the auditor may perform more substantive procedures as of the balance sheet date rather than at interim; may modify the nature of tests to obtain more persuasive evidence; or may increase the extent of testing (e.g., include more items, locations, etc.).

(2) **Strong Control Environment**

When there is a strong control environment, the auditor may perform tests at an interim date rather than at the balance sheet date; may use tests that provide somewhat less persuasive evidence; or may reduce the extent of testing.

R 3. **Risk Assessment** → By management

Risk assessment is an entity's identification and analysis of risks to achievement of its objectives. (Note that this component concerns the assessment by management of risk facing the entity, not the auditor's assessment of control risk.)

a. The entity's risk assessment for financial reporting purposes involves the identification, analysis, and management of business risks relevant to the preparation of fairly presented GAAP financial statements.

b. Relevant accounting risks include, for example, the occurrence of external and internal events and circumstances that may adversely affect the entity's ability to initiate, authorize, record, process, and report financial data.

Auditor/CPA should obtain understanding & knowledge

c. Circumstances from which risks may arise include:

(1) Change in the regulatory or operating environment

(2) New personnel

(3) New or revamped information systems

(4) Rapid expansion of operations

(5) Incorporation of new technology

(6) New business models, products, or activities

(7) Corporate restructuring

(8) Expansion or acquisition of foreign operations

(9) Adoption of new or different accounting principles or pronouncements

d. Management may take action to address risk, or may decide to accept a risk based on cost or other considerations.

e. The auditor should consider whether business risks identified by management may result in material misstatement. If management fails to identify a significant risk, the auditor should consider why the entity's risk assessment process failed.

1 **4. Information and Communication Systems** : auditor/CPA should obtain understanding & knowledge

Information and communication systems support the identification, capture, and exchange of information in a timely and useful manner.

**a. Information**

The information system relevant to financial reporting objectives consists of the procedures (both automated and manual) and records established to initiate, authorize, record, process, and report entity transactions, events, and conditions, and to maintain accountability for the related assets, liabilities, and equity. It encompasses the accounting system as well as any other methods and records that:

(1) Identify and record all valid transactions.

(2) Describe transactions in a timely manner and in sufficient detail to allow proper classification.

(3) Measure and record the proper monetary value of transactions.

(4) Determine and ensure proper recording of transactions and events in the appropriate time period.

(5) Present transactions and related disclosures properly in the financial statements.

b. **Accounting Information System**

The auditor is especially interested in the business processes relevant to financial reporting, and should obtain an understanding of:

(1) The classes of transactions that are significant to the financial statements.

(2) Accounting processing (both automated and manual), from initiation of a transaction to inclusion in the financial statements.

(3) The accounting records (both electronic and manual), supporting information, and specific accounts involved in initiating, authorizing, recording, processing, and reporting transactions.

(4) The way in which other significant events and conditions are captured by the system. Information system

(5) The financial reporting process, including the development of significant accounting estimates and the inclusion of appropriate disclosures.

c. **Communication**

Communication involves providing an understanding of individual roles and responsibilities pertaining to internal control over financial reporting. Communication may be written (policy and procedure manuals, financial reporting manuals, and memoranda), oral, or by example (through the actions of management). The auditor should obtain an understanding of:

(1) The methods used to communicate roles, responsibilities, and significant matters related to financial reporting.

(2) Communications between management and those charged with governance (particularly the audit committee), and between management and external parties, such as regulatory authorities.

M 5. **Monitoring** : auditor/CPA should obtain understanding & knowledge

Monitoring is the process that assesses the quality of internal control performance over time, by assessing the design and operation of controls on a timely basis and taking the necessary corrective actions.

a. Establishing and maintaining internal control is a responsibility of management. Management must monitor controls to determine whether they are operating as intended and whether they have been modified appropriately for changes in conditions.

b. The monitoring process may include:

(1) Ongoing monitoring activities built into normal recurring activities, including regular management and supervisory activities.

(2) Separate evaluations of internal control performance.

(3) An internal audit function that provides both an evaluation of internal control (including its strengths and weaknesses) and recommendations for improvement.

(4) Evaluation of communications from external parties, such as customers (through the payment or questioning of invoices), regulatory agencies, and independent external auditors.

c. The auditor should obtain an understanding of the activities used by the entity to monitor internal control and to initiate corrective actions.

Rule: In a well-designed internal control environment, errors should be prevented and/or detected by employees in the ordinary course of their job/business



E **6. Existing Control Activities**: CPA/auditor should obtain understanding & knowledge

a. Existing control activities are the policies and procedures that help ensure that management directives are carried out and that necessary steps to address risks are taken.

**PASS KEY**

The following will help you remember the control activities in a strong system of internal control:

- Prenumbering documents
- Authorization of transactions
- Independent checks to maintain asset accountability
- Documentation
- Timely and appropriate performance reviews
- Information processing controls
- Physical controls for safeguarding assets
- Segregation of duties

Strong internal control has "PAID TIPS"

b. Control activities relevant to an audit include the following procedures.

Your checkbook P **(1) Prenumbering of Documents**

Prenumbering helps to assure that:

(a) All transactions are recorded (completeness).

(b) No transactions are recorded more than once (existence).

Signed approval A **(2) Authorization of Transactions**

Authorization should occur before commitment of resources.

Checks & balances I **(3) Independent Checks to Maintain Asset Accountability**

Independent checks involve the verification of work previously performed by others. Examples include:

(a) Review of bank reconciliations.

(b) Comparison of subsidiary records to control accounts.

(c) Comparison of physical counts of inventory to perpetual records.

Paper trail D **(4) Documentation**

Documentation provides evidence of the underlying transactions and is a basis for establishing responsibility for the execution and recording of transactions.

Analytical procedures T **(5) Timely and Appropriate Performance Reviews**

(a) Comparison of actual performance to budgets, forecasts, and prior periods.

(b) Comparison of financial and nonfinancial information (for example, the management of a sports team might use attendance data to ascertain the reasonableness of ticket sales).

(c) Review and evaluation of functions or activities (for example, sales reports, receivable reports, etc., may be used to analyze performance and to identify errors).

I (6) **Information Processing Controls**

Information processing general and application controls ensure that transactions are valid, properly authorized, and completely and accurately recorded.

(a) Application controls apply to the processing of individual transactions.

(b) General controls apply to information processing throughout the company.

P (7) **Physical Controls for Safeguarding Assets**

Physical controls for safeguarding assets involve security devices and limited access to programs and restricted areas, including computer facilities. Physical controls include:

Security

(a) Physical segregation and security of assets, protective devices, and bonded or independent custodians (e.g., banks, safe deposit boxes, lock boxes, and independent warehouses).

(b) Authorized access to assets and records (such as through the use of computer access codes, prenumbered forms, and required signatures on documents for the removal or disposition of assets).

(c) Periodic counting and comparison of actual assets with amounts shown in accounting records (e.g., physical counts and inspections of assets, reconciliations, and user review of computer-generated reports).

S (8) **Segregation of Duties**

Segregation of duties involves ensuring that individuals do not perform incompatible duties. Duties should be segregated such that the work of one individual provides a crosscheck on the work of another individual. Generally, assigning different people the responsibilities of authorizing transactions, recording transactions, and maintaining custody of the related assets reduces the opportunities for any individual to both perepetrate and conceal errors or fraud in the normal course of duties.

**PASS KEY**

The examiners frequently test segregation of duties. To help you remember the functions that should not be combined: "Segregation of duties" is your **ARC** to protect against a flood of troubles:

- **A**uthorization
- **R**ecord keeping
- **C**ustody of related assets

Client's internal control should separate these functions

c. The auditor often obtains knowledge about control activities while studying the other components of internal control, and uses judgment to determine whether additional knowledge must be obtained.

(1) An audit does not require an understanding of all control activities.

(2) The auditor's primary consideration should be whether, and how, a control prevents, or detects and corrects, material misstatements.

Rule: The internal control environment should prevent/detect fraud by
- One person
- Not: 1. Collusion
  2. Management override

| SUMMARY OF THE FIVE COMPONENTS OF INTERNAL CONTROL | | |
|---|---|---|
| **Component** | **Description** | **Key Points** |
| C Control Environment | Sets the tone of the organization. | • Integrity<br>• Competence<br>• Participation of those charged with governance<br>• Management philosophy<br>• Organizational structure<br>• Assignment of responsibility<br>• Human resource policies |
| R Risk Assessment | Identification by management of the risks relevant to the preparation of the financial statements. | • Risks are generally related to changes. |
| I Information and Communications Systems | Methods used to classify and report transactions, and to communicate roles and responsibilities. | • Initiating, authorizing, recording, processing, and reporting entity transactions, conditions, and events<br>• Communicating roles and responsibilities |
| M Monitoring | Procedures established to assess the quality of internal control performance over time. | • Internal audit function<br>• Regular management and supervisory activities<br>• Other procedures such as mailing customer statements |
| E Existing Control Activities | Policies and procedures established to ensure that management objectives are carried out. | • Authorization<br>• Segregation of duties<br>• Safeguarding of assets<br>• Asset accountability<br>PAID TIPS |

## II. AUDITOR'S CONSIDERATION OF INTERNAL CONTROL

I M A CPA

### A. Consideration of the COSO Framework

While the five components of internal control provide a useful framework for identifying and evaluating controls, the auditor should be more concerned with whether and how a specific control prevents, detects, and corrects material misstatements, than with the classification of controls into categories.

It is a "CRIME" not to have strong internal control

#### 1. Relevance to the Audit

a. Internal control is relevant to the entire entity or to any of the entity's operating units or business functions.

b. The five components of internal control are applicable to the audit of every entity.

c. Each of the five components of internal control may affect any of the three entity objectives.

2. **Factors Affecting the Application of Framework**

The applicability and importance of internal control components are affected by the entity's size, organization, complexity, information processing methodology, and ownership-management characteristics. The auditor does not need to understand each component with the same degree of detail in every case.

**PCAOB STANDARDS—GUIDANCE FOR ISSUERS**

Management can elect to use the COSO Framework or another recognized internal control framework when establishing and evaluating internal control. PCAOB standards state that if management uses an acceptable internal control framework other than the COSO Framework, the auditor may use that other framework or the COSO Framework when evaluating the design and implementation of controls when performing an audit of financial statements only. However, for integrated audits, the auditor should use the framework used by management in its annual evaluation of the effectiveness of internal control over financial reporting.

## B. Identifying Controls Relevant to Reliable Financial Reporting

Relevant internal controls are internal controls that prevent, detect, and correct material misstatements. Internal controls can impact the financial statements as a whole or a specific class of transactions, account balances, or disclosures.

RMM

1. **Preventive Controls**

Preventive controls are designed to provide reasonable assurance that only valid transactions are recognized, approved, and submitted for processing. Most preventive controls are applied before the processing activity occurs.

2. **Detective Controls**

Detective controls are designed to provide reasonable assurance that errors or irregularities are discovered and corrected on a timely basis. Detective controls are normally performed after processing has been completed.

**PASS KEY**

It is not necessary for the auditor to assess all of an entity's internal controls over financial reporting. The auditor must use judgment to determine which controls should be assessed during the audit. The auditor should focus the assessment of control risk on the entity's relevant controls.

## C. Evaluate the Design and Implementation of Internal Control

The auditor should obtain an understanding of the five components of internal control sufficient to:

1. **Evaluate the Design and Implementation of Relevant Controls**

a. **Design**

Evaluating the design of a control involves determining whether it is capable, individually or in combination with other controls, of preventing or detecting and correcting material misstatements.

CPA req. responsibility: An understanding of each element of "CRIME" as it pertains to financial reporting

b. **Implementation**

A control has been implemented if it exists and is being used. To determine whether internal controls have been implemented, the auditor must obtain evidence about whether the individuals responsible for performing the controls have:

(1) an awareness of the existence of the procedure and their responsibility for its performance; and

(2) a working knowledge of how the procedures should be performed.

c. **Procedures**

Procedures used to obtain evidence about the design and implementation of internal controls include:

(1) Inquiry of entity personnel (inquiry alone is not sufficient)

(2) Observation of the application of controls

(3) Inspection of documents and reports

(4) Observation of the entity's premises and plant facilities

(5) Walkthroughs (described further below)

2. **Assess the Risks of Material Misstatement** : ID types of potential misstatement

An understanding of the design and implementation of an entity's relevant controls is required to complete the assessment of the risks of material misstatement, even when the audit strategy contemplates performing only substantive procedures with no planned reliance on the entity's internal controls.

3. **Design the Nature, Extent, and Timing of Further Audit Procedures**

a. Identify the types of potential misstatements;

b. Consider factors that affect the risks of material misstatement;

c. Design tests of controls, when applicable (covered in more detail later); and

d. Design substantive procedures.

**PCAOB STANDARDS—GUIDANCE FOR ISSUERS**

PCAOB standards state that the nature, timing, and extent of procedures needed to obtain an understanding of internal control depend on the size and complexity of the company, the auditor's existing knowledge of the company's internal control over financial reporting, the nature of the controls, the company's use of IT, the nature and extent of changes in systems and operations, and the nature of the company's internal control documentation.

D. **Walkthroughs**

Walkthroughs trace transactions relevant to financial reporting through the accounting system from inception through recording in the general ledger and presentation in the financial statements.

1. The purpose of walkthroughs is to:

a. Confirm the auditor's understanding of key elements of the entity's information processing system and internal controls.

b. Evaluate the design of the relevant internal controls.

c. Determine whether certain controls have been implemented.

2. A walkthrough can be performed by:

   a. Selecting a single transaction and tracing it through the entity's information processing system from inception to financial reporting.

   b. Identifying the key steps in the processing of a class of transactions from inception to financial reporting and then performing risk assessment procedures for each step. At each step, the auditor should perform procedures for a specific transaction, but not necessarily the same transaction at each step.

3. Walkthrough procedures include inquiry and additional procedures.

   **a. Inquiry**

   To perform walkthroughs, the auditor should make inquiries of those who actually perform the information processing and internal control procedures. Inquiries should include:

   (1) The individual's understanding of the entity's procedures and controls.

   (2) Whether the processing and controls are performed as required and on a timely basis.

   (3) Situations in which the individual and others do not perform the required control procedures.

   (4) The individual's understanding of the processing and controls performed on the information before and after the information is handled by the individual.

   **b. Other Procedures**

   Inquiry alone is not sufficient. The auditor should corroborate inquiry responses by performing additional procedures:

   (1) Observe individuals performing their information processing and control procedures.

   (2) Re-perform the information processing or control procedures.

   (3) Inspect the relevant documents and accounting records.

   (4) Corroborate inquiry responses with others knowledgeable about the information processing and control procedures.

## E. Small and Midsized Entities

Small and midsized entities often use less formal means to achieve internal control objectives. For example, while a small or midsized entity may not have written or extensive policies and procedures manuals or an independent party charged with governance, its management may be more actively involved in financial reporting, or may establish a corporate culture emphasizing integrity. The auditor must use his or her judgment to apply the components of internal control and to make an overall assessment of control risk.

## F. Document the Understanding of Internal Control

The auditor must document the understanding of the design and implementation of the entity's internal controls.

**PASS KEY**

Documentation may include any item the auditor can **F I N D**:

- **F**lowchart
- **I**nternal Control Questionnaire or Checklists
- **N**arrative
- **D**ocumentation from the client, including copies of the entity's procedures manuals and organizational charts.

F **1. Flowcharts** : Depicts auditor's understanding of IC system

A flowchart is a symbolic diagram representing the sequential flow of authority, processes, and documents. It can be an essential aid in understanding and evaluating internal control.

Flowcharting is of use to the auditor in two ways. First, flowcharts of systems are prepared in order to evaluate internal control. Second, IT flowcharts, used as documentation tools in programming, are useful to the auditor in evaluating the internal control in an automated accounting environment.

**a. System Flowcharts**

An adequate flowchart shows the origin of each document in the system, its subsequent processing, and its final disposition. Flowcharts are useful to the auditor in evaluating internal control because they document the steps in a process and the practices in use. The use of standard symbols makes flowcharts easy to understand.

Sample flowcharts for the major transaction cycles appear in Auditing 4.

**b. Program Flowcharts**

IT flowcharts are initially created to document the logic and existing flow of a computer program. The auditor can use these flowcharts to evaluate both the flow of the program and the internal controls related to the IT function in general.

**c. Flowchart Organization**

Flowcharts should:

(1) Show the general flow of documents and data.

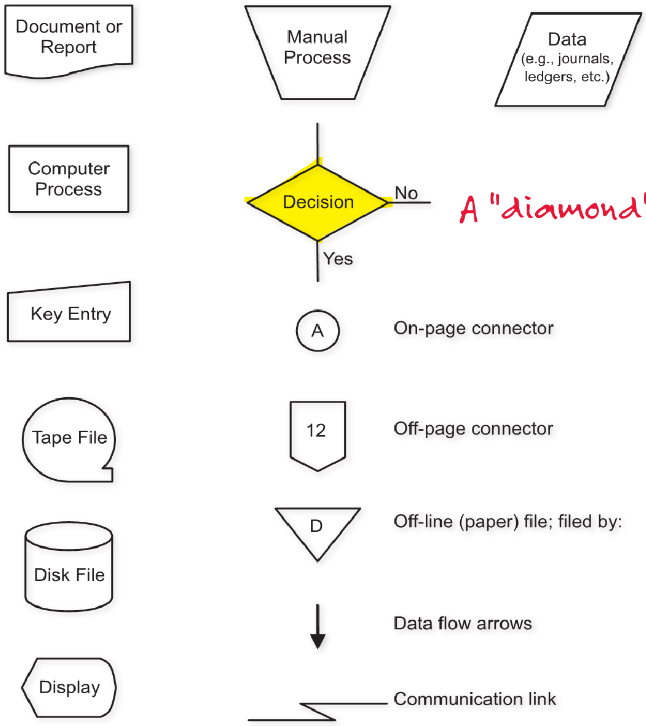
(2) Start at the top of the page and move from top to bottom and from left to right.

(3) Use descriptive wording familiar to the reader.

(4) Avoid intersecting flow lines by using off-page/on-page connectors.

### d. Flowcharting Symbols

The symbols shown below and used in the diagrams in Auditing 4 represent the most commonly used symbols.




A "diamond" is a big decision

I **2. Internal Control Questionnaires** : used for each assertion of management, so as to "COVER U"

An internal control questionnaire generally consists of a list of questions to be answered by "Yes" or "No" response. A negative response is designed to draw attention to a possible weakness in internal control. Written explanations are required for "No" answers. The questionnaire format can also be open-ended, requiring explanation by the employee being interviewed.

The questions address internal controls over an element, account, or process. Specifically, questions should address each of the relevant control procedures.

N **3. Narratives** : hard to "see" weakness in IC

A narrative is a written version of a flowchart. It is a description of the auditor's understanding of the system of internal control. A narrative is prepared by following a sequence of events for a transaction. Note that flowcharts are more appropriate for documenting complex control structures, while written narratives are more appropriate for less complex structures.

| EXAMPLE |
|---|
| **Sales Processing System Written Narrative** |
| Customer purchase orders are received and a sales order is prepared in duplicate. New customers' orders are approved for credit while any orders received from old customers are automatically granted credit. The finished goods department fills the order and sends the sales order to the shipping department where a bill of lading is prepared. A copy of the bill of lading is then sent to the billing department where a sales invoice is prepared. A copy of the sales invoice is sent to the accounts receivable department for posting to the accounts receivable ledger. |

D **4. Documentation From the Client**

An entity's procedures manuals may include documentation of the entity's accounting system and related controls. The entity's organizational chart outlines designated lines of authority and responsibility. Both documents can assist the auditor in understanding the entity's system of internal control.

Audit issue: if evidence is not retrievable, it is difficult to determine timing of control testing and substantive testing

## G. Effect of Information Technology on Internal Control

### 1. Effect on Internal Control

An entity's use of information technology may affect any of the five components of internal control:

IT exception
IT system may make it impossible to resolve the detection risk through substantive testing alone (must do control testing as well)

a. C Management's failure to appropriately address IT risks may negatively impact the *control environment*.

b. R The use of IT may enhance an entity's *risk assessment* by providing more timely information.

c. I Many *information and communication systems* make extensive use of IT, and the way in which IT is used often affects an entity's internal control.

d. M Much of the information used in *monitoring* is provided by IT, and therefore, the accuracy of the IT system is crucial.

e. E The use of IT may affect the way in which *existing control activities* are implemented. Also, the effectiveness of user controls may depend upon the accuracy of information provided to the user by IT systems.

### 2. Manual vs. Automated Controls

Controls in most IT systems include a combination of manual controls and automated controls.

**a. Manual Controls**

Manual controls are internal controls performed by people and are more suitable when judgment and discretion are required, such as when there are:

(1) Large, unusual, or nonrecurring transactions

(2) Potential misstatements are difficult to define or predict

(3) Changes in circumstances that require changes in controls

CPA must document evidence

Manual controls are also used to monitor automated controls. Manual controls, however, may pose additional risks because they can be more easily ignored or overridden, they are subject to human error, and they are less consistent than automated controls.

b. **Automated Controls**

Automated controls are internal controls performed using IT and are more suitable for:

(1) High volume or recurring transactions

(2) Control activities that can be adequately designed and automated

3. **General and Application Controls**

IT specific controls include general controls and application controls:

a. **General Controls**

General controls are policies and procedures that relate to many applications and support the effective functioning and proper operation of the information system. General controls can be categorized as:

(1) Controls over data center and network operations

(2) System software acquisition, change and maintenance controls

(3) Access security controls

(4) Application system acquisition, development, and maintenance controls

Examples of general controls include passwords, change management procedures, back/recovery systems, and administrative rights to the network.

b. **Application Controls**

Application controls apply to the processing of individual transactions and help to ensure that transactions occurred, are authorized, and are completely and accurately processed and reported. Application controls are controls over input, processing, and output, including:

(1) Administrative access rights

(2) Controls over interfaces, integrations, and e-commerce

(3) Checking the mathematical accuracy of records

(4) Maintaining and reviewing accounts and trial balances

(5) Automated edit checks of input data

(6) Manual follow-ups of exception reports

4. **IT Benefits**

IT is used by an entity to improve the efficiency and effectiveness of its internal control. The auditor should consider the effect of such benefits as part of assessing internal control. Benefits may include:

a. The ability to process large volumes of transactions and data accurately and consistently.

b. Improved timeliness and availability of information.

c. Facilitation of data analysis.

d. Reduction in the risk that controls will be circumvented.

e. Enhanced segregation of duties through effective implementation of security controls.

f. Enhanced ability to monitor the performance of the entity's activities and its policies and procedures.

Segregation of duties

C Control group
O Operators
P Programmers
A Analyst (system)
L Librarian

Weakness
Anyone doing or supervising another area

5. **IT Risks** : garbage in → garbage out

The use of IT may also create additional internal control risks. The auditor must evaluate the entity's use of IT to determine whether and to what extent the following risks exist:

Auditor should
1) Document use of programs
2) Perform tests more often during year

a. Potential reliance on inaccurate systems.

b. Unauthorized access to data, which may result in loss of data and/or data inaccuracies.

c. Unauthorized changes to data, systems, or programs.

d. Failure to make required changes or updates to systems or programs.

e. Inappropriate manual intervention.

f. Potential loss of data.

**H. Consider the Limitations of Internal Control** Related to control environment

Internal control provides only reasonable (not absolute) assurance regarding the achievement of objectives due to the following inherent limitations of internal control:

1. Management override of internal control.
2. Human error, which may include errors in the design or use of automated controls.
3. Deliberate circumvention of controls by collusion of two or more people.

**I. Consider the Effects of Service Organizations on Internal Control**

Service Organizations

Many entities use outside organizations to process some portion of their accounting transactions (e.g., ADP and Paychex are service organizations that provide processing for payroll checks and reports).

**1. Relationship Between the Entity and the Service Organization**

A service organization's services are considered to be part of a user entity's information system when those services affect the initiation, execution, processing, or reporting of the user company's transactions. In such cases, the controls placed in operation by the service organization are considered to be part of the user organization's information system.

**2. Service Auditor Reports**

Service organizations often have an auditor perform an attestation examination engagement to report on the controls of the service organization that are relevant to the user entities' internal control over financial reporting. There are two types of reports a service auditor may provide:

a. **Report on Management's Description of the Service Organization's System and the Suitability of the Design of Controls (Type 1 Report)**

A "Type 1 Report" is a report on the design and implementation of a service organization's controls. It does not provide assurance on the operating effectiveness of the controls. A "Type 1 Report" contains the following:

1 of 2
Does not provide the user CPA with a basis for reducing the assessment of control risk

(1) Management's description of the service organization's system.

(2) A written assertion by management of the service organization about whether, in all material respects, and based on suitable criteria:

(a) Management's description of the service organization's system *fairly presents the design and implementation* of the system as of a specified date.

(b) The controls related to the control objectives outlined in management's description were *suitably designed* to achieve the controls objectives *as of a specified date*.

(3) The auditor's opinion on management's assertion.

2 of 2
May provide evidence that would allow a reduction in the assessed level of control risk

**b. Report on Management's Description of the Service Organization's System and the Suitability of the Design and Operating Effectiveness of Controls (Type 2 Report)**

A "Type 2 Report" is a report on the design, implementation, and operating effectiveness of a service organization's controls. A "Type 2 Report" contains the following:

(1) Management's description of the service organization's system.

(2) A written assertion by management of the service organization about whether, in all material respects, and based on suitable criteria:

(a) Management's description of the service organization's system *fairly presents the design and implementation* of the system as of a specified date.

(b) The controls related to the control objectives outlined in management's description were *suitably designed* to achieve the controls objectives *throughout a specified period*.

(c) The controls related to the control objectives outlined in management's description *operated effectively* to achieve the controls objectives *throughout a specified period*.

(3) The auditor's opinion on management's assertion and a description of the service auditor's tests of controls and the results of those tests.

## 3. User Auditor Responsibilities

The user auditor should obtain an understanding of the nature and significance of the services provided by the service organization and the effect on the user entity's internal control, sufficient to identify and assess the risks of material misstatement and design and perform audit procedures responsible to those risks.

a. When a service auditor's report is available, the user auditor may utilize the report in its assessment of the user entity's internal controls.

**(1) Type 1 Report**

A Type 1 Report may aid the user auditor in obtaining an understanding of controls. However, a Type 1 Report is provided when tests of the operating effectiveness of the service organization's controls were not performed, and therefore it does not provide the user auditor with a basis for reducing the assessment of control risk below maximum for areas of the entity's accounting that are affected by the service organization.

(2) **Type 2 Report**

A Type 2 Report provides the user auditor with assurance about the design, implementation, and operating effectiveness of the service organization's internal controls and therefore may provide evidence that would allow a reduction in the assessed level of control risk for areas of the entity's accounting that are affected by the service organization.

Alternatively, such evidence (to allow reduction in assessed risk) can be obtained directly by the user auditor, either by testing the user organization's controls over the service organization's activities, or by performing tests of controls at the service organization.

b. The user auditor should be satisfied regarding:

(1) The service auditor's competence and independence.

(2) The adequacy of the standards under which the Type 1 or Type 2 report were issued.

**4. Reporting by the User Auditor**

a. The user auditor should issue a qualified opinion or a disclaimer of opinion if the user auditor is unable to obtain sufficient appropriate audit evidence regarding the services provided by a service organization relevant to the audit.

b. The user auditor should not make reference to the report of the service auditor in an unmodified opinion issued by the user auditor.

c. The user auditor is permitted to make reference to the work of a service auditor in the user auditor's report to explain a modification of the user auditor's opinion.

# RESPONDING TO THE ASSESSED RISKS OF MATERIAL MISSTATEMENT

| Responding to Assessed Risks |
|---|
| **I**nternal control, entity, and environment—obtain an understanding |
| **M**aterial misstatement—assess the risk |
| **A**ssessed level of risk response |
| **C**ontrol testing |
| **P**erform substantive testing |
| **A**udit evidence—evaluate appropriateness & sufficiency |

## I. RESPONDING TO THE ASSESSED RISKS OF MATERIAL MISSTATEMENT

### A. Levels of Response

In order to reduce audit risk to an acceptably low level, the auditor should develop the following responses to the assessed risks of material misstatement:

1. An overall response to address financial statement level risks.
2. A response at the relevant assertion level, whereby the nature, extent, and timing of audit procedures are designed to address risks related to specific assertions.
3. A response to significant risks.

### B. Overall Response to Financial Statement Level Risk

1. In response to risk assessed at the financial statement level, the auditor may:
   a. Communicate to the audit team an increased need for professional skepticism.
   b. Assign staff with more experience or specialized skills.
   c. Increase the level of supervision.
   d. Incorporate a greater level of unpredictability into the audit.
   e. Make pervasive changes to the nature, extent, or timing of tests, such as shifting substantive procedures closer to period end.

| PCAOB STANDARDS—GUIDANCE FOR ISSUERS |
|---|
| PCAOB standards state that the overall response to financial statement level risk should include an evaluation of the company's selection and application of significant accounting principles. |

2. The auditor's understanding of the control environment will affect his or her assessment of overall risk at the financial statement level.
3. The auditor's general approach to the audit may consist of either a substantive approach, in which substantive procedures are emphasized, or a combined approach, in which both tests of controls and substantive procedures are used.

### C. Response to Risks at the Relevant Assertion Level

1. The auditor should design audit procedures that address the risks of material misstatement for each relevant assertion of each significant account, balance, or disclosure. There should be a clear linkage between the assessed level of risk at the relevant assertion level and the nature, extent, and timing of further audit procedures, including tests of controls and substantive procedures.

**PASS KEY**

Three elements of further audit procedures can be varied by the auditor. An easy way to remember these elements is: We cast our "NET" over the audit:

- Nature
- Extent
- Timing

$$\text{Audit risk} = \overbrace{(\text{Inherent risk} \times \text{Control risk})}^{\text{RMM}} \times \text{Detection risk}$$

N a. **Nature**

The nature of an audit procedure includes both its purpose (test of control vs. substantive procedure) and its type (inspection, observation, inquiry, confirmation, recalculation, reperformance, or analytical procedure).

(1) The higher the assessed risks of material misstatement, the more reliable and relevant audit evidence must be. The auditor varies the nature of audit procedures in order to achieve the desired level of reliability and relevancy.

(2) If the auditor uses information provided by the entity's information system, the accuracy and completeness of that system must be tested.

(3) In responding to assessed risks, the nature of selected audit procedures is of primary importance.

E b. **Extent**

The extent of an audit procedure refers to the quantity to be performed, such as the number of observations to be made or the sample size to be used.

(1) The higher the assessed risks of material misstatement, the greater the extent of audit procedures should be.

(2) The auditor should also consider the tolerable misstatement and the degree of assurance the auditor plans to obtain.

T c. **Timing**

Strong Weak

Audit tests may be performed at an interim date or at period end.

(1) The higher the assessed risks of material misstatement, the closer to period end substantive procedures should be performed.

(2) Performing audit procedures before period end allows earlier identification of significant matters; however, additional evidence is necessary for the remaining period.

(3) In considering the timing of audit tests, the auditor should consider when relevant information is available. Some procedures occur only at certain times and electronic data may not be retained indefinitely.

2. In designing further audit procedures that are responsive to the assessed risks, the auditor should consider:

a. the significance and likelihood of the risk;

b. the characteristics of the transaction, balance, or disclosure;

c. the nature of controls used (especially whether they are manual or automated); and

d. whether the auditor expects to test the operating effectiveness of the controls.

3. **Audit Approach**

The auditor's specific approach to identified risks at the relevant assertion level may consist of either a substantive approach or a combined approach.

a. **Substantive Approach**

Do not test "controls" if ineffective at reducing substantive testing

For certain relevant assertions and risks, only substantive procedures will be performed. This occurs when control risk is assessed at maximum because:

(1) there are no effective controls relative to the specific assertion;

(2) the implemented controls are assessed as ineffective; or

No strong controls to rely upon

(3) it would not be efficient to test the operating effectiveness of controls.

b. **Combined Approach** (Cost/benefit relationship)

Both tests of the operating effectiveness of controls and substantive procedures are used. Typically, if controls are operating effectively, less assurance will be required from substantive procedures.

c. **Tests of Controls May Be Required** = IT

See "pass key" next page

In situations where a significant amount of information is initiated, authorized, recorded, processed, or reported electronically, substantive procedures alone may not be sufficient. Tests of controls are generally required when:

(1) An entity conducts its business using information technology (IT) and no documentation of transactions is produced or maintained, other than through the IT system.

(2) Audit assertions are related to routine day-to-day business transactions that permit highly automated processing with little or no manual intervention.

(3) Audit evidence is obtained in electronic form. The sufficiency and appropriateness of such evidence is dependent on the effectiveness of controls over the accuracy and completeness of the information.

d. **Dual-Purpose Tests**

(1) A dual-purpose test is a test of controls that is performed concurrently with a test of details on the same transaction.

(2) The purpose of a test of controls is to evaluate the operating effectiveness of a control, whereas the purpose of a test of details is to support relevant assertions or to detect material misstatements. A dual-purpose test should be designed to accomplish both objectives.

e. **Results of Testing**

(1) The fact that a substantive procedure does not identify any material misstatements does not necessarily imply that the related control is operating effectively.

(2) Material misstatements that the auditor detects through performance of substantive procedures should be considered by the auditor when assessing operating effectiveness.

(a) If the entity's internal control activities did not identify the material misstatement, it may be considered a significant deficiency or a material weakness (covered in Auditing 5).

**PASS KEY**

**AUDIT APPROACH**

| *Status of Internal Control* | *Risk Level* | *Perform Control Tests* | *Perform Substantive Procedures* |
|---|---|---|---|
| None or Weak | High | No (unless heavy use of IT) | Yes—Maximum |
| Some | Medium | Yes | ↕ |
| Strong | Low | Yes | Minimal (but never eliminate for material balances, transaction classes, or disclosures) |

### D. Response to Significant Risks

For all significant risks, the auditor should:

1. Evaluate the design of the entity's related controls and determine whether the controls have been implemented.
2. If relying on the operating effectiveness of internal controls intended to mitigate significant risk, tests of controls must be performed in the current period. The auditor cannot rely on tests of controls performed in prior periods.
3. Perform substantive procedures that are clearly linked and responsive to the risk. For areas of significant risk, substantive procedures can consist of:
   a. tests of details only; or
   b. a combination of tests of details and substantive analytical procedures.

## II. TESTS OF CONTROLS : strengths & IT

| |
|---|
| **I**nternal control, entity, and environment—obtain an understanding |
| **M**aterial misstatement—assess the risk |
| **A**ssessed level of risk response |
| **C**ontrol testing |
| **P**erform substantive testing |
| **A**udit evidence—evaluate appropriateness & sufficiency |

### A. When to Perform Tests of Controls

In making risk assessments, the auditor should identify those controls that are likely to prevent or detect and correct material misstatements in specific relevant assertions. Obtaining an understanding of a control is not sufficient to determine whether the control is operating effectively.

1. Tests of controls are performed when:
   a. the auditor's risk assessment is based on the assumption that controls are operating effectively; or
   b. when substantive procedures alone are insufficient (i.e., when the entity makes extensive use of information technology).

Inspect client records documenting use & changes to IT programs

2. The auditor is not required to evaluate operating effectiveness as part of obtaining an understanding of the design and implementation of internal control.
   a. Some risk assessment procedures performed to obtain an understanding of internal control may provide evidence about operating effectiveness, even if they were not intended for that purpose.
      (1) For example, as long as there are adequate controls surrounding computer security and program changes, the consistent nature of IT processing may allow procedures performed to determine whether an automated control has been implemented to also serve as a test of that control's operating effectiveness.
   b. If it is efficient to do so, the auditor may choose to test the operating effectiveness of controls concurrently with obtaining an understanding of internal control.

c. Only those controls that are suitably designed to prevent or detect material misstatements are subject to tests of operating effectiveness.

3. In a group audit, tests of controls are required to be performed by the group engagement team or the component auditor when the nature, timing, and extent of work to be performed on the consolidation process or the financial information of the components is based on an expectation that:

a. Group-wide controls are operating effectively, or

b. Substantive procedures alone cannot provide sufficient appropriate audit evidence at the assertion level.

## B. Tests of Operating Effectiveness

Testing the operating effectiveness of controls includes obtaining evidence regarding:

1. Whether the controls were applied at relevant times.
2. How controls were applied.
3. The consistency with which controls were applied.
4. By whom or by what means controls were applied.

Auditor judgment is used to determine the nature, extent, and timing (NET) of tests of controls.

**PCAOB STANDARDS—GUIDANCE FOR ISSUERS**

PCAOB standards state that when performing tests of controls, the auditor must obtain evidence that the controls selected for testing were both designed effectively and operated effectively during the period of reliance. Design effectiveness should be tested by determining whether the company's controls satisfy the company's control objectives and can effectively prevent or detect errors or fraud that could result in material misstatements in the financial statements. Procedures to test design effectiveness include a mix of inquiry, observation, and inspection. Walkthroughs that include these procedures are sufficient to test design effectiveness.

## C. Nature of Tests of Controls

Audit evidence hierarchy

Auditor knowledge
External evidence
Internal evidence
Oral evidence
U-know it

1. Tests of the operating effectiveness of controls, presented in the order of the evidence that they would ordinarily produce, from least to most, include the following: inquiries, observation, inspection, and reperformance. The auditor should use a combination of procedures to obtain sufficient evidence of operating effectiveness.

a. Inquiry alone is not sufficient.

b. Observation is generally pertinent only at the point in time when it is made, so observation should be supplemented with other procedures, such as inquiry, inspection, and reperformance.

2. For some controls, operating effectiveness may be evidenced by documentation; for other controls (such as the assignment of responsibility or segregation of duties), documentation may not be available or relevant. To test such controls, the auditor would likely rely on inquiry and observation.

3. As the planned level of reliance on the operating effectiveness of a control increases, the auditor should obtain more reliable or more extensive audit evidence.

## D. Extent of Tests of Controls

The more extensively a control is tested, the greater the evidence obtained from that test. The auditor should consider the following factors in determining the appropriate extent of testing controls:

1. The frequency of the performance of the control during the period.
2. The length of time during which the auditor wishes to rely on the control.
3. The relevance and reliability of the evidence to be obtained.
4. The extent to which other tests provide audit evidence about the same assertion.
5. The extent to which the auditor wishes to rely on the operating effectiveness of the control to reduce substantive procedures.
6. The expected deviation rate from the control.
7. Additional considerations:
   a. If a control is applied on a transaction basis throughout the period, the auditor should use sampling to test the control.
   b. IT processing is inherently consistent, so it is possible to test only a few instances of the operation of an automated control. Once the auditor has determined that an automated control is functioning as expected, the auditor should determine that it continues to function effectively.

## E. Timing of Tests of Controls

### 1. Testing at a Particular Time vs. Testing Throughout a Period

a. When tests of controls are performed at one particular time, they provide evidence that controls operated effectively only at that time. Controls tested throughout the period provide evidence of operating effectiveness during that period.

b. The auditor may choose to test the operating effectiveness of a control only at one particular time, but then supplement this test with other tests that provide evidence for the remainder of the period. For example, tests relating to the modification and use of computer programs may provide evidence that a control operated consistently throughout the period.

c. Tests related to period-end controls, such as tests of controls over the counting of physical inventory at period end, may be performed at only one time, if the auditor only intends to rely on the control at that one time.

d. Controls that are tested only during an interim period should be supplemented by additional evidence for the remaining period. Roll forward

### 2. Evidence Obtained in Prior Audits

Evidence obtained in a prior audit about the operating effectiveness of controls may be used in the current audit, as long as the auditor obtains evidence about whether changes in those controls have occurred.

a. If controls have changed since they were last tested, operating effectiveness must be retested in the current period.

b. Even if controls have not changed, operating effectiveness must be tested at least once every third year.

   (1) Care should be taken to avoid the possibility that all controls are tested in the same period, with no controls tested in the intervening two periods.

c. The auditor may also choose, based on the circumstances, to retest operating effectiveness more often than once every third year.

(1) Generally, the higher the assessed risk, or the greater the intended reliance on controls, the more frequently the auditor will choose to test operating effectiveness.

(2) A weak control environment or a significant manual component to relevant controls may also result in more frequent testing, or in choosing not to rely on prior period evidence at all.

d. The auditor may not rely on audit evidence obtained in prior audits for controls that mitigate a significant risk.

**F. Results of Tests of Controls**

After performing tests of controls, the auditor may conclude that audit evidence indicates that controls are:

1. Operating effectively and can be relied upon. The auditor then proceeds to substantive procedures based on the assessed risks of material misstatement.

2. Not operating effectively, in which case the auditor can:

   a. test alternate controls; or

   b. address the risks of material misstatement with more reliable and extensive substantive procedures.

- $ balances
- Analytical procedures
- Ratios

## III. SUBSTANTIVE PROCEDURES :

**A. Substantive Procedures**

| |
|---|
| **I**nternal control, entity, and environment—obtain an understanding |
| **M**aterial misstatement—assess the risk |
| **A**ssessed level of risk response |
| **C**ontrol testing |
| **P**erform substantive testing |
| **A**udit evidence—evaluate appropriateness & sufficiency |

1. Substantive procedures are used to detect material misstatements at the relevant assertion level.

2. The nature, extent, and timing (NET) of substantive procedures should be responsive to the assessed risks of material misstatement, including the results of tests of controls and the planned level of detection risk.

3. Regardless of the assessed risks of material misstatement, substantive procedures are required for each material transaction class, account balance, or disclosure.

4. Substantive procedures should include:

   a. Agreement of the financial statements to the underlying accounting records.

   b. Examination of material journal entries or adjustments made while preparing the financial statements.

   c. Evaluation of the overall presentation of the financial statements in accordance with GAAP, including disclosures.

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**B. Nature of Substantive Procedures**

**1. Types of Substantive Procedures**

There are two types of substantive procedures:

a. Tests of details applied to transaction classes, account balances, and disclosures. $

b. Substantive analytical procedures.

**2. Selection of Substantive Procedures**

The auditor may use only substantive analytical procedures, only tests of details, or a combination of both.

a. Substantive analytical procedures are often used when there is a large volume of predictable transactions.

b. Tests of details are generally more appropriate when obtaining evidence regarding the existence and valuation of account balances.

c. If tests of controls indicate that controls are operating effectively, then substantive analytical procedures may be sufficient to reduce detection risk to an acceptably low level.

d. If tests of controls indicate that controls are not operating effectively or tests of controls were not performed, then the auditor may perform tests of details only.

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## C. Extent of Substantive Procedures

1. The more extensively a substantive procedure is performed, the greater the evidence obtained from the procedure. The extent of substantive procedures is affected by:

   a. The overall risks of material misstatement: The greater these risks, the less detection risk that can be accepted, and the greater the extent of substantive procedures.

   b. Control risk: If controls are operating effectively, the extent of substantive procedures may be reduced.

2. In designing tests of details, the extent of substantive procedures generally refers to sample size.

   a. Sample size is affected by the planned level of detection risk, the tolerable misstatement, the expected misstatement, and the nature of the population. Sampling will be further discussed in Auditing 5.

3. In planning substantive analytical procedures, the auditor should consider the amount of difference from the expected results that will be acceptable.

   a. The acceptable amount of difference is primarily based on the level of tolerable misstatement, but should also include consideration of the possibility that a combination of misstatements could aggregate to an unacceptable amount.

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## D. Timing of Substantive Procedures

Substantive procedures can be performed during an interim period, at period end, or after period end.

**1. Interim Testing**

Auditing at Interim

a. If substantive procedures are performed at an interim date, the auditor should perform further substantive procedures, or substantive procedures combined with tests of controls, to provide a reasonable basis for extending audit conclusions to period end. Roll forward

b. Performing substantive procedures at an interim date increases the risk that the auditor will not detect material misstatements in the financial statements. The longer the period between the interim date and period end, the greater the risk.

c. In certain situations, such as those in which there is an identified fraud risk or high risk of material misstatement, the auditor may choose to perform substantive procedures at or near period end.

Substantive interim testing
Only if risk of material misstatement is low

d. If substantive analytical procedures are to be used to extend audit conclusions from interim testing to period end, the auditor should consider whether:

(1) Period-end balances are reasonably predictable with respect to amount, relative significance, and composition.

(2) The entity's accounting procedures are appropriate.

(3) The entity's information system will provide sufficient information to allow investigation of unusual or unexpected transactions or balances.

e. If misstatements are discovered at an interim date, the auditor should modify the related risk assessment and the procedures to be performed for the remaining period, or should consider repeating audit procedures at period end.

f. Evidence obtained from substantive tests performed in a prior audit generally is not sufficient for the current period.

## IV. EVALUATING THE SUFFICIENCY AND APPROPRIATENESS OF AUDIT EVIDENCE

| |
|---|
| **I**nternal control, entity, and environment—obtain an understanding |
| **M**aterial misstatement—assess the risk |
| **A**ssessed level of risk response |
| **C**ontrol testing |
| **P**erform substantive testing |
| **A**udit evidence—evaluate appropriateness & sufficiency |

### A. Results of Further Audit Procedures

The results of further audit procedures may lead the auditor to:

1. Reassess the risks of material misstatement.
2. Identify control deficiencies as a result of tests of controls or substantive procedures. Control deficiencies will be discussed further in Auditing 5.
3. Identify misstatements as a result of substantive procedures. The evaluation of misstatements will be further discussed in Auditing 4.

### B. Revising the Assessed Risks of Material Misstatement

The results of further audit procedures should be used to determine whether the assessed risks of material misstatement at the relevant assertion level is still appropriate. Audit evidence obtained may cause the auditor to modify the initial risk assessment. When there is a change in the assessed level of risk, the auditor should modify planned audit procedures accordingly.

1. The results of tests of controls may indicate that controls are not functioning effectively, which will result in a higher assessment of the risks of material misstatement and more extensive and reliable substantive procedures.
2. Material misstatements discovered while performing substantive procedures that were not detected by the entity's controls are considered a material weakness that will cause the auditor to change the judgment regarding the effectiveness of internal control and revise the assessed risks of material misstatement.

Professional skepticism

3. If fraud is discovered, the auditor should not assume that an identified instance of fraud or error is an isolated occurrence, but instead should consider whether such an instance affects the assessed risks of material misstatement.
4. All relevant audit evidence should be considered, regardless of whether it is consistent with or contradicts relevant assertions in the financial statements.

## C. Sufficiency and Appropriateness of Evidence

The auditor uses judgment to evaluate the sufficiency and appropriateness of audit evidence, but should consider the:

1. Significance and likelihood of potential misstatements.
2. Effectiveness of management's responses and controls.
3. Experience gained during previous audits.
4. Results of audit procedures performed.
5. Source, reliability, and persuasiveness of audit evidence obtained.
6. Understanding of the entity and its environment.

**PCAOB STANDARDS—GUIDANCE FOR ISSUERS**

PCAOB standards state that the following factors are relevant to the conclusion that sufficient appropriate evidence has been obtained:

- The significance of uncorrected misstatements and the likelihood of their having a material effect on the financial statements, individually or in aggregate, considering the possibility of further undetected misstatements.
- The results of audit procedures performed in the financial statement audit and in the audit of internal control over financial reporting (if the audit is an integrated audit).
- The auditor's risk assessment.
- The appropriateness of the audit evidence obtained.

## D. Documentation Requirements

The auditor should document:

1. The overall response addressing assessed risk at the financial statement level.
2. The nature, extent, and timing of further audit procedures.
3. The linkage of those audit procedures with assessed risks at the relevant assertion level.
4. The results of audit procedures.
5. The conclusions reached regarding the use of prior period audit evidence in evaluating the current operating effectiveness of controls.

Risk
Overstate
Assets & revenue

↓ouch
Test for: 1. Existence
2. Support
3. Occurrence

F/S
T/B
G/L
Sub-ledgers
Books
Documents
Events

↑race
Test for: 1. Completeness
2. Coverage

Risk
Understate
Liabilities & expenses

# AUDITING 4

*Audit Evidence*

## NOTES

# Support for audit opinion = AUDIT EVIDENCE

## I. GENERAL

*Audit evidence* is all the information the auditor uses to arrive at the conclusions on which the audit opinion is based. It includes information in written or electronic form as well as observable assets or activities, and it must be obtained to support auditor conclusions. The use of sampling to collect audit evidence will be discussed in Auditing 5. Audit evidence is gathered throughout the audit when performing:

(i) Risk assessment procedures

(ii) Tests of controls

(iii) Substantive procedures

(iv) Other audit procedures

Objective of substantive testing

Detect material misstatement in FS

Audit evidence may also come from other sources, such as previous audits or a firm's quality control procedures for client acceptance and continuance.

## II. TYPES OF AUDIT EVIDENCE

Audit Evidence

Audit evidence consists of underlying accounting records and corroborating evidence. The auditor should have access to all pertinent accounting data and corroborating audit evidence.

Otherwise, scope limitation

### A. Accounting Records

Accounting records consist of records of initial entries and any supporting records. For example, accounting records include checks, records of electronic fund transfers, invoices, contracts, ledgers, journal entries, and worksheets. The auditor tests the accounting records through analytical procedures and substantive procedures, such as retracing procedural steps, recalculation, and reconciliation. Note that accounting records alone do not provide sufficient support for the audit opinion. However, internal consistency among the accounting records provides some evidence that the financial statements are presented fairly.

### B. Corroborating Evidence

Corroborating evidence includes minutes of meetings, confirmations, industry analysts' reports, data about competitors, and information obtained through observation, inquiry and inspection. Corroborating evidence provides additional support and gives validity to the recorded accounting data.

### C. Evidence in Electronic Form

In certain entities, some of the accounting records or corroborating evidence may be available only in electronic form. Source documents may be replaced by electronic messages, or business may be transacted electronically. While electronic evidence may be initially available, it may not be retrievable indefinitely. The auditor should therefore consider the time during which information exists or is available in determining the nature, extent, and timing of auditing procedures.

## III. OBTAINING SUFFICIENT APPROPRIATE AUDIT EVIDENCE

### A. Reasonable Basis for an Opinion

The audit evidence must persuade the auditor that the ending balances in the financial statements are fairly presented. The audit provides *reasonable assurance* regarding the fairness of the financial statements. The auditor is *not* a guarantor, and, in most cases, cost-benefit considerations prohibit an examination of 100% of the accounting data. Therefore, it is generally not practical or possible to obtain assurance beyond all doubt, and the auditor usually must rely on evidence that is *persuasive,* rather than *conclusive.* Persuasiveness is a subjective concept and relates uniquely to each audit.

Note that while the cost-benefit relationship may be a valid reason for performing only certain procedures, cost alone or difficulty in obtaining evidence is *not* a valid basis for omitting a procedure for which there is no appropriate alternative. Thus, the auditor must exercise professional judgment in determining the procedures to be performed and the sufficiency and appropriateness of the evidence gathered.

### B. Sufficiency of Audit Evidence - Valid and relevant

Sufficiency refers to the quantity of audit evidence. The auditor must use professional judgment in determining the amount and kinds of evidence sufficient to support an opinion. As mentioned previously, judgments about materiality and audit risk underlie this determination. The amount of evidence gathered directly affects the level of detection risk, which is the risk that the auditor's evidence-gathering procedures will not be sufficient to support the financial statement assertions.

The auditor's decision regarding the sufficiency of evidence is influenced by:

1. The risk of material misstatement: greater risk implies more evidence will be required.
2. The quality of audit evidence: less audit evidence may be required when that evidence is of higher quality.

Note that even if it is conclusive, evidence regarding a small portion of a balance or a single transaction is generally insufficient to support the entire balance. For instance, overwhelming evidence of the existence of a $500 account receivable is not sufficient to substantiate a total accounts receivable balance of $1,000,000.

### C. Appropriateness of Audit Evidence

Appropriate audit evidence must be both reliable and relevant. The appropriateness of evidence depends on its being pertinent, objective, timely, and corroborated by other evidence.

Reliability

#### 1. Reliability of Evidence

Reliability of audit evidence is dependent on the circumstances under which it is gathered. Reliability of evidence is also influenced by its source and nature.

**a. Auditor's Direct Personal Knowledge**

Any evidence obtained directly by the auditor (i.e., through observation, physical examination, inspection, or recalculation) provides more persuasive evidence than evidence obtained indirectly.

**b. External Evidence**

External evidence obtained from independent sources outside the enterprise provides greater assurance of reliability than internally generated evidence. There are two types of external evidence:

(1) evidence sent directly to an independent auditor; and

(2) evidence received and held by the client.

Evidence sent directly to the auditor (e.g., a bank confirmation) is more valid than evidence received and held by the client.

**c. Importance of Effective Controls**

Internal evidence generated within the enterprise is not as reliable as external evidence, but strong, effective internal controls improve reliability. Internal evidence includes purchase orders, sales orders, general ledgers, and management reports.

**d. Documentary Evidence**

Audit evidence in documentary form is more reliable than oral evidence, and original documentation is more reliable than photocopies, faxes, or documents that have been converted to electronic form. Oral evidence consists of statements made by clients concerning the procedures involved in a given transaction, often resulting in the explanation of an account balance. Oral evidence is the least reliable form of evidence.

**e. Consistency of Evidence**

When audit evidence obtained from different sources is consistent, a greater degree of assurance is provided.

**f. Information Produced by the Client**

If the auditor intends to use information produced by the client, the auditor should determine whether the information is sufficiently reliable for the auditor's purposes by:

(1) Obtaining evidence about the accuracy and completeness of the information.

(2) Evaluating whether the information is sufficiently precise and detailed for the auditor's purposes.

**PASS KEY**

Memorize the following hierarchy of audit evidence (from most reliable to least reliable):

1. Auditor's direct personal knowledge & observation
2. External evidence
3. Internal evidence
4. Oral evidence

**Relevance**

### 2. Relevance of Evidence

COVER-U

Evidence must relate to the financial statement assertion(s) under consideration. For example, accounts receivable confirmations are relevant to the existence of receivables, not to their valuation, because a customer can confirm that a receivable exists, but this does not necessarily imply that the customer has the intent or the ability to pay.

**PCAOB STANDARDS—GUIDANCE FOR ISSUERS**

PCAOB standards state that the relevance of audit evidence depends on:

- the design of the audit procedure, in particular whether it is designed to test the assertion directly and whether it is designed to test for understatement or overstatement; and
- the timing of the audit procedure.

## D. Evaluation of Audit Evidence → Evaluate mgt. assertions → Detect material misstatement

The evaluation of audit evidence must take into consideration the achievement of audit objectives. The auditor must be unbiased in this evaluation, considering all evidence regardless of whether it conflicts with the financial statements.

If audit evidence obtained from one source is inconsistent with evidence from another source, or if the auditor has doubts about the reliability of information used as audit evidence, the auditor should determine whether additional audit procedures are required to resolve the matter and should consider the effect of the matter on other aspects of the audit.

**Substantive Procedures**

# IV. SUBSTANTIVE PROCEDURES = $ balances/transaction totals/disclosure amounts

Substantive procedures are designed to detect material misstatements at the assertion level. They consist of:

(i) tests of details applied to transactions, balances, and disclosures; and

(ii) substantive analytical procedures.

## A. Tests of Details

Tests of details consist of audit procedures used to gather evidence to support the account balances as reflected in the financial statements. Tests of details are performed on ending balances, the details of transactions, or a combination of the two. If an account has a high turnover rate with many transactions occurring during the year, the auditor generally will concentrate testing on the ending balance. When this approach is used, the auditor must be satisfied that internal control is strong. An alternative approach is to test the details of transactions. This approach is employed when the account being substantiated has relatively few transactions occurring during the year (e.g., an account for land or treasury stock). One approach need not be used exclusively, and a combination of the two might be appropriate. For example, during an audit of the sales revenue account, the auditor uses procedures to substantiate the ending balance while also performing extensive procedures on samples of transactions and related accounts (e.g., cash receipts and accounts receivable).

### 1. Examples of Substantive Procedures

The auditor may test the details supporting transactions, balances, and disclosures through inspection, observation, inquiry, confirmation, recalculation, reperformance, etc. Tests of details are discussed in greater detail below.

## B. Analytical Procedures

Analytical procedures are evaluations of financial information made by a study of plausible relationships among both financial and nonfinancial data, and they generally involve comparisons of recorded amounts to independent expectations developed by the auditor. As discussed in Auditing 3, the auditor must use analytical procedures for planning and overall review in all audits, and also may decide to use analytical procedures as substantive tests.

The following chart summarizes the use of analytical procedures:

| *Phase* | *Requirement* | *Purpose* |
|---|---|---|
| Planning | Required | To assist the auditor in understanding the entity and its environment.<br>Used for risk measurement to alert the auditor to problem areas requiring attention. This serves a vital planning function. |
| Substantive procedures | Not required | As a substantive test to obtain audit evidence about specific management assertions related to account balances or transactions.<br>The evidence is circumstantial and generally additional corroborating evidence (such as documentation) must be obtained. |
| Final review | Required | To assist the auditor in the final review of the overall reasonableness of account balances. |

> *Note:* In recent years, there has been an increased emphasis on the use of analytical procedures.

# V. ANALYTICAL PROCEDURES

## A. Procedures

Analytical Procedures

### 1. Comparisons of Financial Data

Analytical procedures generally include a review of the current and prior year's financial statements and the current year's budget. Comparisons are made between the current year's actual and budgeted financial statements, and between the current year's actual and prior year's actual financial statements. Comparisons are also made within the current year's financial statements for internal consistency. For example, net income on the income statement should agree with the increase in retained earnings on the statement of retained earnings.

### 2. Ratio Analysis

When performing analytical procedures, the auditor may choose to compare ratios developed from recorded amounts to expected ratios developed by the auditor. A complete review of pertinent ratios is presented later in this chapter.

## B. Substantive Analytical Procedures

In certain situations, analytical procedures are a more effective and efficient means of gathering evidence than tests of details, and in those cases, analytical procedures may be used as substantive tests.

### 1. Designing and Performing Substantive Analytical Procedures

When designing and performing analytical procedures as substantive procedures, the auditor should do the following:

a. Determine the analytical procedures that are suitable for testing the assertion(s), taking into account the assessed risks of material misstatement and tests of details.

b. Evaluate the reliability of the data from which the auditor's expectation is to be developed. The following factors are relevant when determining whether the data is reliable:

(1) The source and comparability of the information.

(2) The nature and relevance of the information.

(3) Controls over the preparation of the information.

c. Develop an expectation of recorded amounts or ratios and evaluate whether the expectation is sufficiently precise to identify material misstatement. Expectations may be developed based on:

(1) financial information for comparable prior periods;

(2) anticipated results from budgets and forecasts;

(3) relationships among data within the current period;

(4) industry norms; and

(5) relationships of financial data with nonfinancial information.

d. Perform the analytical procedures and compare the results of the analytical procedures with the expectations.

e. Investigate any significant differences by:

(1) inquiring of management and obtaining appropriate evidence relevant to management's responses; and

(2) performing other audit procedures as necessary.

### 2. Efficiency and Effectiveness of Analytical Procedures

The efficiency and effectiveness of analytical procedures in detecting potential misstatements depends, among other things, on the following four factors.

**a. Nature of the Assertion Being Tested**

Analytical procedures are most effective and efficient for assertions in which potential misstatements are not apparent from an examination of the detailed evidence or when such detail is unavailable.

① IS accounts are more predictable
② Accounts with management discretion are less predictable



**b. Plausibility and Predictability of the Data Relationship**

In order to use analytical procedures as a substantive test, the auditor must have a clear understanding of the relationships among data. It is possible that data may appear to be related when in fact they are not, and failure to properly understand such situations may lead to erroneous conclusions.

In order to provide an appropriate level of assurance, analytical procedures should be based on predictable relationships. More predictable relationships are provided by data generated in a stable, rather than dynamic, environment; involve income statements, rather than just balance sheet accounts; and involve transactions that are less subject to management discretion.

**c. Availability and Reliability of Data Used to Develop the Expectation**

Data used by the auditor to develop expectations should be both readily available and reliable. Reliability of data is enhanced if it is obtained from external rather than internal sources, obtained from independent internal sources (i.e., unrelated to those who are responsible for the amount being audited), generated under effective internal controls, audited previously, and obtained from a variety of sources.

**d. Precision of the Expectation**

More precise expectations are more effective in detecting misstatements. An expectation is more precise when it is developed at a sufficiently detailed level, and when there is effective identification and consideration of factors that significantly influence the relationship.

### 3. Documentation Requirements

When an analytical procedure is used as the principal substantive test of a significant financial statement assertion, the auditor is required to document the:

a. Auditor's expectation.

b. Factors considered in the development of the expectation.

c. Results of the comparison of the expectation to recorded amounts.

d. Additional audit procedures performed in response to significant unexplained differences.

e. Results of such additional procedures.

## C. Limitations of Analytical Procedures

Analytical review comparisons are based on expected plausible relationships among data. Differences do not necessarily indicate errors or fraud, but simply indicate the need for further investigation. Changes in an account, changes in accounting principle, and inherent differences between industry norms and the client all contribute to fluctuations in expected amounts.

# VI. TESTS OF DETAILS

## A. Directional Testing

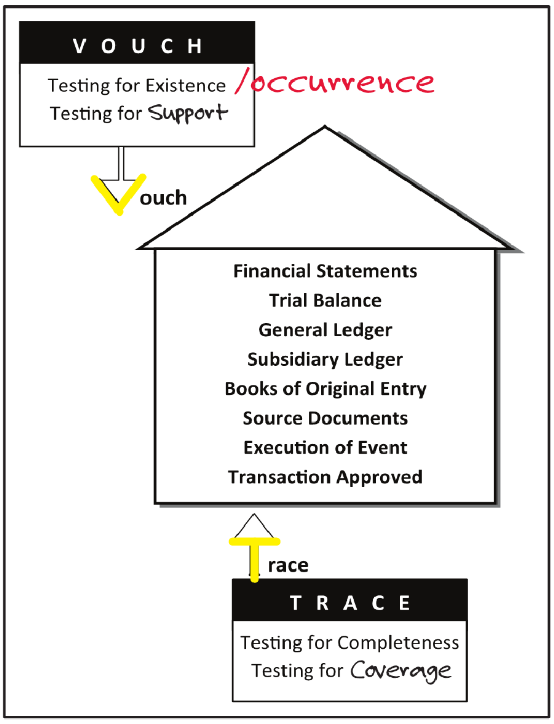
**Tests of Details**

Directional testing refers to testing either forward or backward. Tracing forward from source documents to journal entries provides evidence of completeness. Vouching backward from journal entries to source documents provides evidence of existence. For instance, if evidence were being gathered relative to the completeness assertion for sales, the auditor would want to verify that all sales were being recorded on the income statement. The auditor would focus attention on sales invoices and supporting documents such as customer purchase orders and client shipping documents, and then trace forward through the accounting system up to the income statement. On the other hand, if the possibility of overstated sales (the existence assertion) were being addressed, the auditor would focus attention on the income statement (all recorded sales) and then vouch backward through the ledger and journals and ultimately to the supporting source documents such as customer purchase orders and related shipping documents.

**PASS KEY**

Many exam questions require the candidate to determine which assertion is being tested by a specific audit procedure. Remember that if a test starts with items in the financial statements, the proper assertion is most likely to be existence—the auditor searches for evidence indicating that the item truly exists and has not been created by management. On the other hand, if a test starts with source documents, it is most likely related to the completeness assertion, since the goal is probably to make sure all transactions (as identified by the source documents) have been included in the financial statements.

Risk of overstatement
- Revenue
- Assets




Risk of understatement
- Expenses
- Liabilities

## B. External Confirmation

### 1. Definition

External confirmation is a form of audit evidence obtained as a direct written response to the auditor from a third party, either in paper form or by electronic or other medium. *An oral response to a confirmation request does not meet the definition of an external confirmation.* Confirmation involves obtaining representations from independent external third parties about account balances and transactions or events. Confirmations can also be used to confirm the terms of agreements, contracts, or transactions between an entity and other parties, or to confirm the absence of certain conditions, such as side agreements.

**PASS KEY**

The auditor's direct access to information held by a third party meets the definition of an external confirmation if the auditor is provided by the third party with electronic access codes or information necessary to access a secure website where data is held that addresses the subject matter of the confirmation. When access is provided to the auditor by management, the evidence obtained by the auditor does not meet the definition of an external confirmation.

#### a. Positive Confirmation vs. Negative Confirmation

A positive confirmation is a request that the confirming party respond directly to the auditor by providing the requested information or by stating that the party agrees or disagrees with the information in the request. Positive A negative confirmation is a request that the confirming party respond directly to the auditor only if the confirming party disagrees with the information in the request. Negative

### 2. External Confirmation Procedures

The auditor should maintain control over external confirmation requests, including:

a. Determining the information to be confirmed or requested.

b. Selecting the appropriate confirming party or parties.

c. Designing the confirmation requests. Factors to be considered when designing confirmation requests include:

(1) The assertion(s) being addressed

(2) Identified risks of material misstatement, including fraud

(3) The layout and presentation of the request (e.g. positive or negative)

(4) Prior experience on the audit

(5) The method of communication (e.g., paper or electronic)

(6) Management's authorization or encouragement to the confirming parties to respond to the auditor

(7) The ability of the confirming party to provide the requested information

d. Sending the requests, including follow-up requests when necessary, to the confirming party or parties.

3. **Management's Refusal to Allow the Auditor to Perform External Confirmation Procedures**

If management refuses to allow the auditor to perform external confirmation procedures, the auditor should evaluate the validity and reasonableness of management's refusal, evaluate the effect of the refusal on the risks of material misstatement, including the risk of fraud, and on the nature, extent, and timing of other audit procedures, and perform alternative procedures. If the auditor determines that management's refusal is unreasonable or the auditor is unable to obtain sufficient appropriate evidence from alternative procedures, the auditor should communicate with those charged with governance and determine the implications for the auditor's opinion.

4. **Results of External Confirmation Procedures**

a. **Reliability of Responses to Confirmation Requests**

All confirmation responses carry some risk of interception, alteration, or fraud. If the auditor determines that a response to a confirmation request is not reliable, the auditor should evaluate the implications on the assessment of the risks of material misstatement, including fraud, and on the related nature, extent, and timing of other audit procedures.

When responses are received electronically, the auditor may address the reliability of the responses by directly contacting the confirming party to validate the identity of the sender and the accuracy of the information received. An electronic confirmation system or a process that creates a secure confirmation environment may mitigate the risks of interception or alteration.

b. **Confirmation Nonresponses**

A nonresponse is a confirmation request returned undelivered or a failure of the confirming party to respond, or fully respond, to a positive confirmation request. The auditor may send additional confirmation requests when a previous request has not been received within a reasonable time. For each confirmation nonresponse, the auditor should perform alternative procedures.

A nonresponse to a confirmation request may indicate a previously unidentified risk of material misstatement. For example, a greater number of nonresponses than expected may indicate a previously unidentified fraud risk factor.

c. **Oral Responses**

An oral response to a confirmation request does not meet the definition of an external confirmation because it is not a direct written response. If the auditor has not concluded that a direct written response to a positive confirmation is necessary to obtain sufficient appropriate audit evidence, the auditor may take an oral response into consideration when designing the alternative audit procedures required to be performed for nonresponses.

d. **Exceptions**

An exception is a response that indicates a difference between the information in the entity's records and the information provided by the confirming party. All exceptions should be investigated to determine whether they are indicative of material misstatement, fraud, or deficiencies in internal control over financial reporting. Exceptions that result from timing or measurement differences, or clerical errors do not represent material misstatements.

## C. Standard Auditing Procedures

In performing an audit, the auditor gathers evidence using a variety of procedures to accomplish specific objectives. Sampling, which will be covered in Auditing 5, is an aspect of the performance of most audit procedures. The specifics for the sampling plan (objective, population, sample size, method of selection) are included in the audit plan for each procedure and are documented along with the results and evaluation of the results.

The following standard procedures are used in every audit as risk assessment procedures, tests of controls, or substantive tests.

**PASS KEY**

Candidates should try to use proper auditing terminology. If a question asks for audit procedures, words such as foot, cross-foot, inquire, vouch, examine, inspect, review, confirm, analyze, recalculate, reconcile, observe, and trace should be used.

F

### 1. Footing, Cross-Footing, and Recalculation

An auditor may verify the mathematical accuracy of statements and schedules by adding down (footing), adding across (cross-footing), or recomputing amounts. For example, the auditor may substantiate the valuation of financial accounts and the allocation of items such as depreciation, amortization, and accruals by recomputing those items.

I

### 2. Inquiry

Inquiry consists of requesting information from knowledgeable parties both internally (e.g., managers and supervisors) and externally (e.g., attorneys and bankers). Examples include inquiries about pending litigation or pledged or obsolete inventories.

Inquiry is used extensively throughout most audits. However, inquiry of company personnel alone is generally considered insufficient and therefore should be used in conjunction with other audit procedures. In using inquiry, the auditor should:

a. Consider the specific characteristics (knowledge, objectivity, qualifications, etc.) of the person to whom the inquiry is directed.

b. Ask appropriate questions.

c. Evaluate the response and take appropriate action (e.g., following up with additional inquiry, modifying planned audit procedures, etc.)

V

### 3. Vouching

**Existence Occurrence**

Vouching is directional testing in which the auditor examines support for what has been recorded in the records and statements, going from the financial statements *back* to supporting documents. The objective of vouching is to gather evidence regarding possible overstatement errors (the existence or occurrence assertions).

Revenue & assets
are not overstated

E 4. **Examination/Inspection**

The auditor may inspect or examine records, documents, or tangible assets. Records or documents may be internal or external, and may be in paper or electronic form.

Inspection or examination generally provides evidence about the existence assertion, rather than about ownership, rights, obligations, or valuation. Examination may also provide evidence of the terms of contracts, loans, and commitments. The procedure of inspecting documents is often referred to as examination of evidence, and includes the activities of scanning, scrutinizing, and reading. For example, the auditor may *scan* or *scrutinize* entries in general ledger accounts for a period, looking for evidence of unusual amounts or unusual sources of input, which, if found, would be investigated further. The auditors should *read* the minutes of the board of directors' meetings, shareholder meetings, and management committee meetings.

C 5. **Confirmation**

As already discussed, confirmation is a specific type of inquiry that involves obtaining representations from independent external third parties about account balances and transactions or events. Examples include bank confirmations of the amount on deposit or of a loan outstanding, or a confirmation from a customer regarding the existence of a receivable balance at a certain date.

A 6. **Analytical Procedures**

Analytical procedures consist of evaluations of financial information made by a study of meaningful relationships among data, to help highlight unusual fluctuations that could be the result of errors or fraudulent omissions or overstatements. *Scanning* may also be considered an analytical procedure, as the auditor uses professional judgment to search for large, significant, or unusual items in the accounting records.

R 7. **Reperformance**

Reperformance occurs when an auditor independently performs procedures or controls that were originally performed as part of an entity's internal control.

R 8. **Reconciliation**

Reconciliation substantiates the existence and valuation of accounts. It involves comparing financial amounts from two independent sources for agreement, such as reconciling the physical inventory count with the perpetual inventory records. Other examples include reconciling the cash balance per the books with the balance per bank, and reconciling lead schedules to general ledger amounts.

O 9. **Observation**

Observation occurs when an auditor looks at a process or procedure performed by others. For example, at the beginning of an audit, the auditor may tour the client's facilities to gain an understanding of the client's business, or the auditor may observe the client's employees taking a physical inventory to obtain firsthand knowledge regarding ending inventory.

Note that while observation provides the auditor with direct personal knowledge, the evidence provided applies only to the point in time during which the observation occurred. The auditor should also be aware that a process or procedure may be performed differently when the client is aware that the auditor is observing.

T

Completeness

10. **Tracing**

As with vouching, tracing is directional testing. However, tracing is looking for coverage in the opposite direction from vouching. Tracing starts with the source documents and traces *forward* to provide assurance that the event is being given proper recognition in the books and records. The objective of tracing is to gather evidence regarding possible understatement errors (the completeness assertion).

C

11. **Cutoff Review** Expenses & liabilities are not understated

The auditor should perform a cutoff review of year-end transactions, especially inventory, cash, purchases, sales, and accruals.

A

12. **Auditing Related Accounts Simultaneously**

Certain accounts can be audited simultaneously, such as:

a. Long-term liabilities and interest expense

b. Capital additions to plant and equipment and repairs and maintenance expense

c. Investments and dividend and interest income

R

13. **Representation Letter**

At the conclusion of fieldwork, the independent auditor must obtain a management representation letter from the client. The representation letter is discussed further in Auditing 5.

S

14. **Subsequent Events Review**

The auditor is required to perform certain procedures for the period after the balance sheet date up to the date of the auditor's report. Evidence not available at the close of the period often becomes available before the auditors complete their fieldwork and write their report. For example, the bankruptcy of the auditor's client's customer shortly after the balance sheet date indicates that the financial strength of the customer had probably deteriorated before year-end. The settlement of a pending lawsuit constitutes evidence that a real (rather than a contingent) liability may have existed at year-end. Decreases in long-term debt occurring after year-end may indicate that such debt should be reported as a current liability on the balance sheet. Evidence becoming available after the balance sheet date should be used in making judgments about the valuation of assets and liabilities on the balance sheet date.

## D. Review of Relevant Assertions - COVER-U

As described in Auditing 3, the main assertions relevant to the audit of account balances, transactions, and presentation and disclosure are:

1. **Account Balances** *(CVER)*

When audit procedures relate to asset, liability, and equity account balances, the most relevant assertions are:

C

a. **Completeness**

All assets, liabilities, and equity interests that should have been recorded have been recorded.

V

b. **Valuation, Allocation, and Accuracy**

Assets, liabilities, and equity interests are recorded fairly and at appropriate amounts, and any resulting valuation or allocation adjustments are appropriately recorded.

E c. **Existence and Occurrence**

Assets, liabilities, and equity interests exist.

R d. **Rights and Obligations**

The entity holds or controls the rights to assets and liabilities are the obligations of the entity.

**PASS KEY**

When auditing asset balances the auditor generally focuses on testing the existence assertion (rather than the completeness assertion) because assets are more likely to be overstated (existence) than understated (completeness). The auditor generally focuses on testing the completeness assertion for liability balances because liabilities are more likely to be understated than overstated.

"E"

"C"

2. **Transactions and Events** *(COVEU)*

When testing transactions, the most relevant assertions are:

C a. **Completeness**

All transactions and events that should have been recorded have been recorded.

O b. **CutOff**

Transactions and events have been recorded in the correct accounting period.

V c. **Valuation, Allocation, and Accuracy**

Amounts and other data relating to recorded transactions and events have been recorded appropriately.

E d. **Existence and Occurrence**

Transactions and events that have been recorded have occurred and pertain to the entity.

U e. **Understandability and Classification**

Transactions and events have been recorded in the proper accounts.

**PASS KEY**

When auditing revenue transactions, the auditor generally focuses on testing the existence/occurrence assertion (rather than the completeness assertion) because revenues are more likely to be overstated (existence) than understated (completeness). The auditor generally focuses on testing the completeness assertion for expense transactions, because expenses are more likely to be understated than overstated.

3. **Presentation and Disclosure** *(CVRU)*

When testing financial statement disclosures, the most relevant assertions are:

C a. **Completeness**

All disclosures that should have been included in the financial statements have been included.

V b. **Valuation, Allocation, and Accuracy**

Financial information and other information are disclosed fairly and at appropriate amounts.

R

c. **Rights and Obligations, and Occurrence**

Disclosed events and transactions have occurred and pertain to the entity.

U

d. **Understandability and Classification**

Financial information is appropriately presented and described and disclosures are clearly expressed.

HW

| | C | O | V | E | R | U |
|---|---|---|---|---|---|---|
| Account Balances | C | | V | E | R | |
| Transactions & Events | C | O | V | E | | U |
| Presentation & Disclosure | C | | V | | R | U |

**PCAOB STANDARDS—GUIDANCE FOR ISSUERS**

PCAOB standards state that the financial statement assertions are:

- Completeness
- Existence
- Occurrence
- Allocation
- Presentation
- Rights
- Obligations
- Valuation
- E
- Disclosure

The PCAOB assertions are "CEO APROVED."

The PCAOB also states that the auditor may base the audit work on different financial statement assertions if the assertions are sufficient for the auditor to identify the types of potential misstatements and to respond appropriately to the risks of material misstatement.

## E. Selecting Items for Testing to Obtain Audit Evidence

Designing substantive procedures and tests of controls includes determining the means of selecting items for testing. The following methods can be used:

### 1. Selecting All Items

Selecting all items in an account or all occurrences of a control may be done when the population consists of a small number of high dollar value items, the audit procedure can be automated and applied to the entire population, or the audit procedure is designed to respond to a significant risk and other means of selecting items for testing do not provide sufficient appropriate evidence.

### 2. Selecting Specific Items

Selecting specific items refers to the testing of all items in a population that have a specific characteristic, such as testing key items that are important for accomplishing the objective of the procedure or exhibit some other characteristic, or testing all items over a certain amount. When specific items are selected for testing, the results of the audit procedure cannot be projected to the population.

### 3. Audit Sampling

Audit sampling is the application of an audit procedure to less than 100 percent of the items in the account balance or class of transactions for the purpose of evaluating some characteristic of the balance or class. Audit sampling is further discussed in Auditing 5.

## F. Matching Auditing Procedures to Specific Assertions

A workable outline for developing an audit plan uses the financial statement assertions approach. Although audit procedures for each account balance, transaction and disclosure vary significantly, a generic framework can be developed using the financial statement assertions. Certain audit procedures relate specifically to the six main financial statement assertions (COVERU):

HW

| *Assertion* | *Auditing Procedure* |
|---|---|
| *Completeness* | 1. **Tracing** of transactions forward, starting from source documents through their accounting recognition and ultimately to the financial statements. Note that this directional test is the opposite of vouching (the directional test for the existence/occurrence assertion).<br>2. **Analytical review** procedures. The auditor should consider how certain items might be omitted from the account balance, such as unrecorded liabilities or omissions of pledged assets.<br>3. **Observation** of processes and procedures. |
| *CutOff* | 1. **Cutoff procedures** to analyze transactions before and after year end for proper accounting period recognition. |
| *Valuation, Allocation and Accuracy* | 1. **Inspection** of documentation supporting transactions.<br>2. **Footing** and cross-footing of schedules.<br>3. **Independent recalculation.** Examples would be aging of accounts receivable to substantiate the value of the allowance account, or the recalculation of depreciation charges. A prime area for recalculation are estimates made by the client.<br>4. **Reconciliation** of supporting schedules to general ledger line items. |
| *Existence and Occurrence* | 1. **Confirmation** of accounts with third parties.<br>2. **Observation, inspection, and examination** of assets, processes, and procedures. (These provide very persuasive forms of evidence.)<br>3. **Vouching** of transactions from financial statements back to supporting documents. |
| *Rights and Obligations* | 1. **Inspection** of documentation supporting transactions, inspection of contracts, etc. |
| *Understandability and Classification* | 1. **Inspection** of documentation supporting transactions.<br>2. **Review** of all related disclosures for compliance with GAAP.<br>3. **Inquiry of management** regarding disclosures for the account and for related accounts. |

This basic financial statement assertion outline is by no means a complete audit plan, but it does provide a good starting point when addressing audit plans for a given account.

# AUDIT PROCEDURES BY TRANSACTION CYCLE

## I. TRANSACTION CYCLES

Audits are generally performed by transaction cycle. The most common transaction cycles are listed in the chart below. Auditing by transaction cycle enables the auditor to gather evidence for related accounts, transactions, and disclosures simultaneously. This makes the audit process more efficient.

| CYCLE | DESCRIPTION |
|---|---|
| *Revenue* | Includes sales revenues, receivables, and cash receipts |
| *Expenditure* | Includes purchases, payables, and cash disbursements |
| *Inventory* | Includes perpetual inventory, physical counts, and manufacturing costs |
| *Investments* | Includes investments in debt and equity and the income received from investments |
| *Property, Plant, and Equipment* | Includes acquisitions and disposals and related depreciation expense |
| *Payroll and Personnel* | Includes payroll (salaried and hourly) and personnel functions |
| *Financing* | Includes debt and equity financing, repayments to borrowers, interest expense, and dividends |

***

**PASS KEY**

Transaction cycles are frequently tested on the exam.

## II. REVENUE CYCLE

↓ouch - Biggest audit concern
Overstatement [Assets, Revenues]

### A. Fraud Risk

As stated in the discussion of fraud risk in Auditing 3, there should be a presumption in every audit that there is the risk of material misstatement due to revenue recognition fraud. Common revenue frauds include:

1. Early revenue recognition.
2. Holding the books open past the close of the accounting period.
3. Fictitious sales.
4. Failure to record sales returns.
5. Side agreements used to alter sales terms and conditions to induce customers to accept goods and services they otherwise do not need.
6. Channel stuffing achieved by convincing distributors to purchase more inventory than they can sell in the near term.

Another common fraud related to the revenue cycle is the overstatement of receivables, achieved by overstating balances, reporting fictitious balances, or understating the allowance for uncollectible accounts.

Risk reduced by segregation of duties [Authority, Record keeping, Custody] but

Problem if
1. Collusion
2. Override

### B. Internal Control—*Sales*

Sales

Under strong internal control, segregation of the functions in a sales transaction should exist as follows:

1. **Preparation of the Sales Order**

   The sales function begins with the receipt of a customer purchase order by the sales department. If it is determined that the order can be filled, a serially numbered sales order is prepared and sent to the credit department for approval.

   PAID TIPS

2. **Credit Approval** - Valuation

   Authority

   The credit department determines whether or not the customer may receive goods on open account. If the order is approved, a copy of the approved sales order is sent to the shipping department, the billing department, and the accounting department.

3. **Shipment**

   Custody

   In the shipping department, a serially numbered bill of lading is prepared and a copy is sent to the customer. The goods are shipped, and at this point a receivable is created.

4. **Billing**

   Record keeping

   The billing department prepares a serially numbered sales invoice. Shipping documents, sales orders, and invoices are compared to assure that all shipments were based on valid customer orders and were properly billed. Prices and discounts are applied to the invoice, and necessary extensions and footings are computed. The invoice is then sent to the customer and to the accounts receivable department.

5. **Accounting**

   The sale is entered into the sales journal, and a receivable is recorded.

### C. Internal Control—*Accounts Receivable*

Receivables

1. **Sales**

   A receivable is recorded in the accounts receivable control account in the general ledger and in the accounts receivable subsidiary ledger. Periodically, an independent person should reconcile these two records.

2. **Collection of Cash Receipts**

   When payment is received from the customer, the receivable is eliminated.

3. **Uncollectible Receivables**

   An aging schedule is prepared and sent to the credit department for use in carrying out its collection program. At some point, uncollectible receivables should be written off. Controls for writing off receivables include proper authorization (by the treasurer) and record keeping. Without proper control, amounts subsequently collected easily could be misappropriated by employees.

   Auditor can observe the preparation of the aging schedule to support lower CR

PAID TIPS

### 4. Sales Returns

Returned goods must be examined to ensure that they correspond with the reason for return before credit is given. A serially numbered receiving report may be used as a sales return slip. Once the return is approved, the related outstanding receivable is eliminated.

Credit memos should not be prepared by individuals who collect or receive cash payments on accounts receivable; to do so would be an inadequate segregation of duties.

### 5. Sales Discounts

Sales discount procedures and records should be reviewed to ensure that discounts are properly given and recorded. This ensures that receivables are not overstated.

## D. Internal Control—*Cash Receipts*

Cash Receipts

### 1. Collection of Cash Receipts

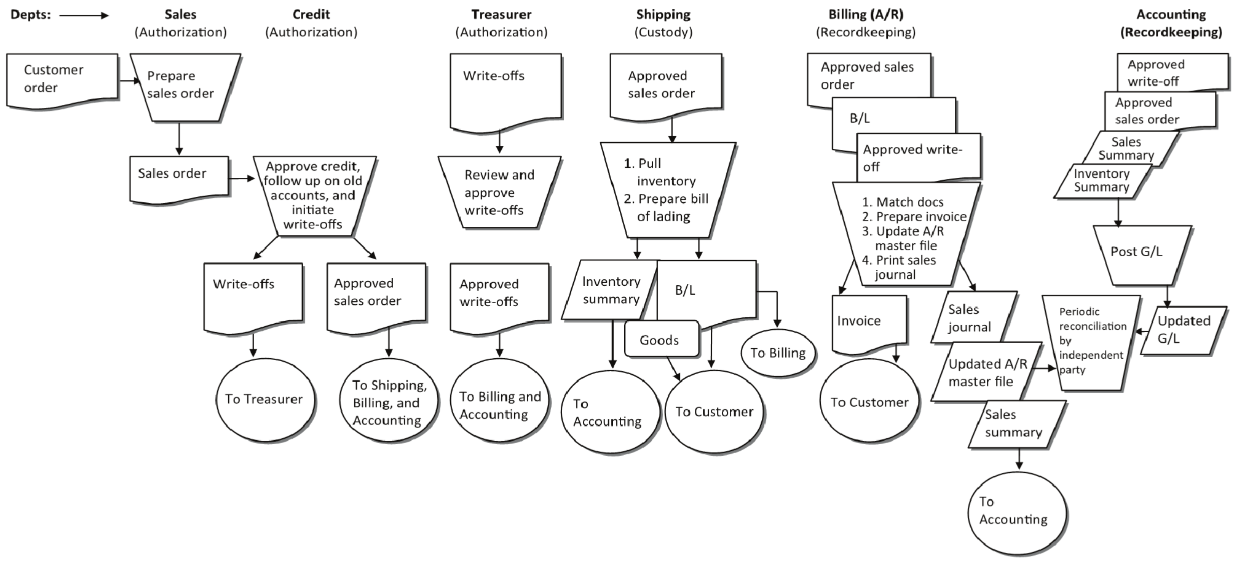
Incoming mail must be opened by a person who does not have access to the accounts receivable ledger. The receipts should be listed in detail with one copy and the actual receipts sent to the cashier to prepare the bank deposit, another copy sent to the accounts receivable department for entry in the accounts receivable subsidiary records, and a third copy sent to the accounting department for entry in the general ledger accounts receivable control account. The accounts receivable department should match the details from the bank deposit ticket with the details from the remittance advices. This will reveal any discrepancies. Cash collections should be restrictively endorsed upon receipt and deposited daily. Devices such as cash registers or lock boxes should be used as safeguards.

Ideal safeguard

## E. Internal Control—*Flowchart Overview*

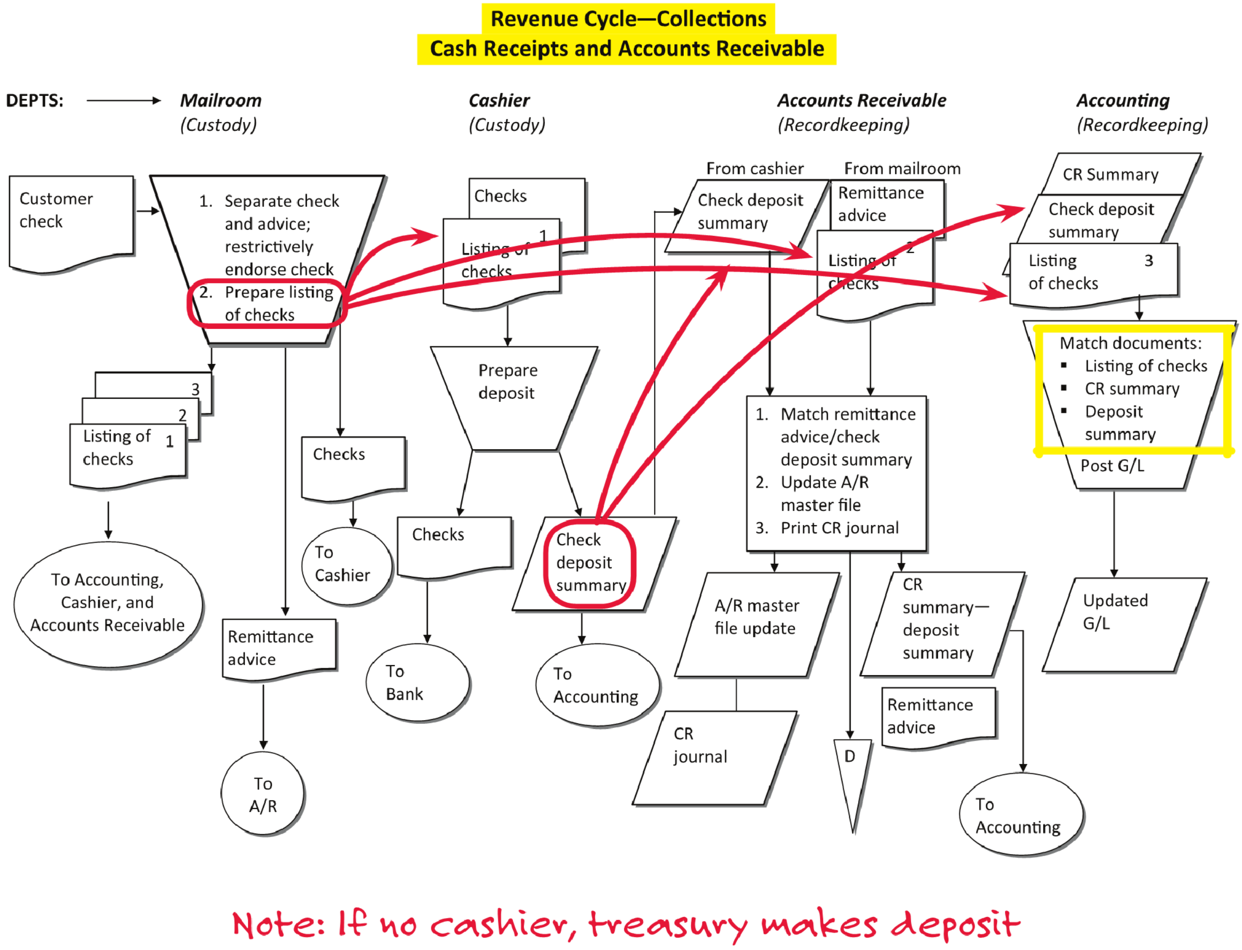
### 1. Sales Flowchart

**Revenue Cycle—Sales**




ARC

## 2. Collections Flowchart




*Note:* The Appendix: Control Procedures and Tests of Controls contains information on revenue cycle control procedures and tests of controls. Please review this Appendix before completing your homework for this lecture.

## F. Substantive Procedures Related to the Revenue Cycle

**PASS KEY**

Existence is generally a more relevant assertion than completeness when auditing the revenue cycle, because the risk that accounts receivable and sales will be overstated (existence) is high, while the risk that accounts receivable and sales will be understated (completeness) is low.

Balances **1. Auditing Accounts Receivable**

**a. Completeness**

The auditor should obtain an aged trial balance of accounts receivable and *trace* the total to the general ledger control account.

**b. Valuation, Allocation, and Accuracy**

The auditor should examine the results of confirmations (a test of accuracy) and test the adequacy of the allowance for uncollectible accounts (a test of valuation). Procedures used to test the adequacy of the allowance for uncollectible accounts are outlined in the discussion of accounting estimates presented later in this lecture.

**c. Existence and Occurrence**

The auditor should confirm a sample of accounts receivable (see the discussion of accounts receivable confirmations below).

**d. Rights and Obligations**

The auditor should review bank confirmations and debt agreements for liens on receivables. The auditor should also inquire of management and review debt agreements and board minutes for evidence that accounts receivable have been factored or sold.

Transactions **2. Auditing Sales Transactions**

The following tests of details may also be performed as tests of controls or dual-purpose tests. The cutoff procedure is performed most often as a substantive procedure.

**a. Completeness**

The auditor should *trace* a sample of shipping documents to the corresponding sales invoices, and to the sales journal and accounts receivable subsidiary ledger.

**b. Cutoff**

The auditor should compare a sample of sales invoices from shortly before and after year-end with the shipment dates and with the dates the sales were recorded in the sales journal. The auditor should also analyze the record of sales returns after year-end.

**c. Valuation, Allocation, and Accuracy**

The auditor should compare prices and terms on a sample of sales invoices with authorized price lists and terms of trade to determine whether sales are recorded at the appropriate amount.

**d. Existence and Occurrence**

The auditor should *vouch* a sample of sales transactions from the sales journal to the sales invoice back to the customer order and shipping documents.

e. **Understandability and Classification**

The auditor should examine a sample of sales invoices for proper classification into the appropriate revenue accounts.

Disclosure

3. **Auditing Presentation and Disclosure**

a. **Completeness**

The auditor should ensure that all required disclosures related to accounts receivable and sales have been included in the notes to the financial statements. Revenue cycle disclosures include:

(1) Revenue recognition method(s).

(2) Revenue by reportable segment.

(3) Related party revenues and receivables.

(4) Receivables by type (trade, officer/employee, affiliates) and term (short-term and long-term).

(5) Pledged or discounted receivables.

b. **Valuation, Allocation, and Accuracy**

The auditor should read the footnotes and other information related to accounts receivable and sales to determine whether the information is accurate and presented at the appropriate amounts.

c. **Rights and Obligations and Occurrence**

The auditor should determine whether any receivables have been pledged, assigned or discounted, and, if so, determine if disclosure is required. The auditor should compare disclosures to other audit evidence to ensure that all disclosed information related to accounts receivable and sales has occurred.

d. **Understandability and Classification**

The auditor should read all accounts receivable and sales related disclosures to ensure that they are understandable.

## G. Accounts Receivable Confirmations

Receivable Confirmation

The auditor should review the accounts receivable schedule for accuracy and collectibility. Confirmation of accounts receivable is a required generally accepted auditing procedure unless: (i) receivables are immaterial; (ii) confirmation would be ineffective; or (iii) inherent and control risks are very low and evidence provided by other procedures is sufficient to reduce audit risk to an acceptably low level. If confirmations are not sent, the auditor must document how omission of this procedure was alternatively tested.

Best
① Large $ amounts
② Expect errors/disputes
③ Weak IC



1. **Positive Confirmations**

Generally, the auditor sends (to the client's customer) a confirmation stating the amount owed. The customers are requested to return a statement to the auditor indicating whether they agree with the amount and to provide information about any exceptions. Positive confirmations should be used when there are large individual accounts, expected errors, or items in dispute, and when internal control is weak.

Note that positive confirmations may also be "blank," which means that the recipient is requested to fill in the balance. Blank forms provide a greater degree of assurance (since the recipient cannot simply sign off without actually checking the balance) but may also result in lower response rates because a greater effort is required for response.

Confirmation responses received electronically (e.g., faxes, e-mails) should be verified by calling the sender. The sender should also be requested to mail the original confirmation directly to the auditor.

The auditor should consider the types of information respondents will be readily able to confirm. For instance, some accounting systems facilitate the confirmation of single transactions rather than entire balances. In such cases, the auditor would either confirm individual invoices, or would include a client-prepared statement of account showing details of the customer's account balance being confirmed.

Note

Non-response ≠ Exception

Note that confirmations generally provide evidence regarding existence and rights and obligations. They do not provide reliable evidence regarding valuation (e.g., customers may confirm a balance owed despite an inability to pay) or completeness (e.g., customers may not report understatement errors).

Not as good
① Low risk
② Small balances
③ Expect customer attention

2. **Negative Confirmations**

No response → 2nd/3rd request → Alternative procedures

Negative confirmations may be used to confirm accounts receivable when:

a. the combined assessed level of inherent and control risk is low;

b. a large number of small account balances are being confirmed; and

c. there is no reason to expect that recipients of the requests will ignore them.

Negative confirmations are less effective than positive confirmations because lack of a response does not provide explicit verification of the existence of the receivable.

3. **Confirmation Exceptions**

Accounts receivable confirmation exceptions occur when there is a disparity between the amount of the receivable recorded in the client's accounting records and the amount of the receivable confirmed by the client's customer. For confirmation exceptions, the auditor should determine whether the exception is due to a timing difference or a misstatement.

a. **Timing Differences** - Investigate

Timing differences occur when there is a delay in the recording of the transaction by the client or their customer. For example, an entity may correctly record a receivable on December 31 when the goods are shipped to the customer, but the customer may not record the payable until the goods are received on January 5. This is not a misstatement.

b. **Misstatements** - Investigate

A confirmation exception would be indicative of misstatement if the exception is due to any of the following errors or frauds:

(1) Fictitious sale

(2) Misappropriation of cash

(3) Goods sent to the wrong customer

(4) Invoice sent to the wrong customer

(5) Payment applied to the wrong customer account

(6) Incorrect price or quantity charged to the customer

Additionally, a confirmation exception could be due to a dispute between the client and the customer because the customer claims that the goods do not meet their specifications, that the goods were damaged in transit, or that the price of the goods is in dispute.

4. **Confirmation Nonresponses**

Nonresponses should be followed up with second (and sometimes third) confirmation requests. The client may be asked to intervene. The auditor should perform alternative procedures, such as inspecting shipping documents or reviewing subsequent cash receipts, when confirmation responses are not received. Alternative procedures may not be necessary if a 100% overstatement of the accounts receivable from the nonresponding customers would be immaterial, as long as there is no unusual pattern to the nonresponses.

↑race - Biggest concern is understatement of expenses & liabilities

## III. EXPENDITURE CYCLE

### A. Internal Control—*Purchases*

Purchases

The following functions in a purchase transaction should be segregated:

1. **Purchase Requisition**

The purchase requisition starts the purchasing cycle. The department in need of the asset or services sends a properly approved, serially numbered requisition to the purchasing department. The requisitioning department should not have the authority to actually place the purchase order. This would indicate a weakness in internal control.

2. **Purchase Orders** PAID TIPS

The purchasing department should place the order only after giving proper consideration to the time to order and the quantity to order. The purchasing department should also obtain competitive bids from various suppliers to make sure that the best price is obtained. The purchase order is issued only after proper approval. For internal control purposes, it is best that prenumbered purchase orders be used. There should be multiple copies that will be sent to: (i) the requisitioning department; (ii) the vendor; (iii) the receiving department; and (iv) the accounting department. If the purchase order is canceled, all copies should be recalled and filed so that every purchase order number is accounted for.

3. **Receipt of Goods or Services**

Blind copy

The copy of the purchase order sent to the receiving department serves as an authorization to accept the goods when they arrive. It is preferable that the copy not indicate the quantity ordered. Thus, the receiving department is forced to count the goods upon arrival. A receiving report is prepared by this department and forwarded to the accounting department. The goods are forwarded to the requisitioning department.

**B. Internal Control—*Accounts Payable***

A/P

The accounting department has three functions: (i) to record the payable; (ii) to approve the invoice for payment; and (iii) to record the payment after it is paid by the Treasurer.

1. **Recording the Payable**

A
R
C

The copy of the purchase order sent to the accounting department notifies them that there will be a future cash disbursement. The receiving report is compared with the purchase order and the vendor's invoice as to quantity to prevent payment of charges for goods in excess of those ordered and received. The accounting department records the goods as received in inventory, and records a payable.

2. **Approving Invoice for Payment and Recording Payment** - Indicate DR/CR

A
R
C

When the invoice arrives, the accounting department approves it by matching the invoice, purchase order, receiving report, and (sometimes) the requisition. When payment is made, the payable is reversed. The accounting department should ensure that the invoice amount is correct, and that it accurately reflects any purchase discounts, before approving it for payment.

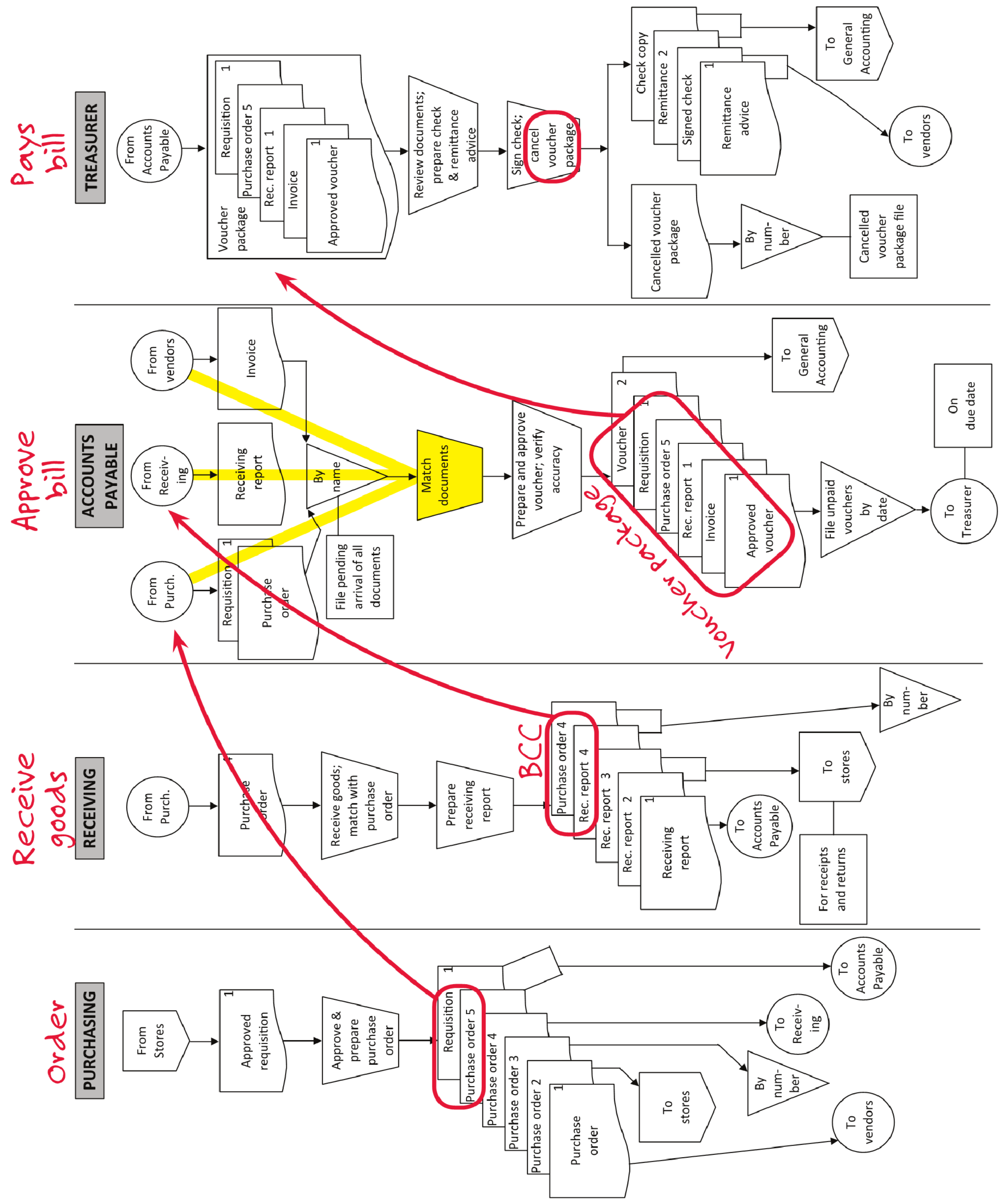
**C. Internal Control—*Cash Disbursements*** - Treasury pays the bill

It is best for internal control purposes to pay invoices by check. For effective internal control, the functions of approving the payment and signing the checks should be segregated. Approved voucher packets (matched invoice, purchase order, receiving report, and requisition) prepared by the accounting department (accounts payable) are received by the Treasurer, who prepares, signs, and mails the checks and cancels all supporting documents after payment. Paid vouchers are returned to the accounting department for posting of the payment and filing of the documents.

*Note:* The Appendix II: Control Procedures and Tests of Controls contains information on expenditure cycle control procedures and tests of controls. Please review this Appendix before completing your homework for this lecture.

## D. Internal Control—*Flowchart Overview*

Expenditure Cycle—Purchases, Payables, and Disbursements



## E. Substantive Procedures Related to the Expenditure Cycle

Balances

### 1. Auditing Accounts Payable

**PASS KEY**

For accounts payable, the completeness and accuracy assertions are generally more relevant than the existence and rights and obligations assertions, because the risk of understatement is higher than the risk of overstatement.

#### a. Completeness

The auditor should perform the following procedures:

(1) Agree the accounts payable listing to the general ledger.

(2) Obtain a sample of vendor statements and agree to the vendor accounts.

Review Jan. payments

Were the expenses incurred in Nov./Dec.?

Was the liability recorded/accrued?

(3) **Perform a Search for Unrecorded Liabilities**

The auditor should select cash disbursements made subsequent to year-end and examine the supporting documentation (e.g., receiving reports, vendor invoices, etc.). The auditor looks for items that should have been recorded at the balance sheet date, but were not.

Note that cash disbursements made subsequent to year-end may be identified by reviewing the cash disbursements journal, subsequent bank statements, or the voucher register.

The auditor should also examine open vouchers, receiving reports, vendors' invoices, and statements received for a period after year-end as part of the search for unrecorded liabilities.

#### b. Valuation, Allocation, and Accuracy

The auditor should perform the following procedures:

(1) Obtain the accounts payable listing, foot the listing, and agree the listing to the general ledger.

(2) Obtain a sample of vendor statements and agree the amounts to the vendor accounts.

(3) Review the results of accounts payable confirmations (see below).

#### c. Existence and Occurrence

The auditor should *vouch* selected amounts from the accounts payable listing to the voucher packages. The auditor may also confirm accounts payable.

(1) **Accounts Payable Confirmations** - Not required

Accounts payable confirmations are not required because good external evidence to support accounts payable is generally available. However, confirmations of accounts payable may be sent when internal control is weak, when there are disputed amounts, or when monthly vendor statements are not available. Typically, vendors with small or zero balances would be selected for confirmation. *Note that although confirmations are generally used to test existence, the accounts payable confirmation is primarily a test of completeness that also provides evidence of existence.*

Accounts payable confirmations are similar to those used for accounts receivable. Accounts payable confirmations are positive and generally "blank" (i.e., they do not state a balance). The objective is to determine whether accounts payable are understated.

The major limitation of accounts payable confirmations is that they may only be sent to recorded liabilities. If a material error were present in accounts payable, it would most likely involve unrecorded liabilities; as such, no record would exist. On the other hand, unrecorded liabilities generally surface eventually, as when unpaid vendors stop delivering goods.

**d. Rights and Obligations**

The auditor should review a sample of voucher packages for the presence of the purchase requisition, purchase order, receiving report and vendor invoice to verify that the accounts payable are owed by the entity.

Transactions

**2. Auditing Purchase Transactions**

The following substantive tests may also be performed as tests of controls or dual-purpose tests.

**a. Completeness**

The auditor should *trace* a sample of vouchers to the purchase journal.

**b. Cutoff**

The auditor should compare dates on a sample of vouchers with the dates the transactions were recorded in the purchase journal. The auditor should also examine purchases before and after year-end to determine if they were recorded in the proper period.

**c. Valuation, Allocation, and Accuracy**

The auditor should recompute the mathematical accuracy of a sample of vendor invoices.

**d. Existence and Occurrence**

The auditor should test a sample of vouchers for authorization and the presence of the receiving report.

**e. Understandability and Classification**

The auditor should verify the account classification of a sample of purchases.

Disclosures

**3. Auditing Presentation and Disclosure**

**a. Completeness**

The auditor should ensure that all required disclosures related to accounts payable and purchases have been included in the notes to the financial statements. Required disclosures include:

(1) Payables by type (trade, officer/employee, affiliates) and term (short-term and long-term).

(2) Purchase contracts and purchase commitments.

(3) Related party purchases and payables.

(4) Expenses by segment.

b. **Valuation, Allocation, and Accuracy**

The auditor should read the footnotes and other information related to accounts payable and purchases to determine whether the information is accurate and presented at the appropriate amounts.

c. **Rights and Obligations and Occurrence**

The auditor should compare disclosures to other audit evidence to ensure that all disclosed information related to accounts payable and purchases has occurred.

d. **Understandability and Classification**

The auditor should read all accounts payable and purchase related disclosures to ensure that they are understandable. The auditor should determine whether material long-term payables or nontrade payables require separate disclosure.

## IV. CASH CYCLE

Cash

### A. Fraud Risk

Cash is an area with high fraud risk, especially when internal control is weak. Lapping and kiting are two common cash fraud schemes.

1. **Lapping** - Today's CR cover yesterday's theft

The theft of cash is often concealed by failing to account for cash receipts. The most common of these methods is known as lapping. Lapping involves withholding and not recording current receipts of cash or checks. The unrecorded receipt is covered by applying a subsequent receipt to the previously unrecorded account.

a. **How to Prevent and Detect Lapping**

As the auditor
Inspect date checks are deposited vs. when the receivable was credited

Safeguards against lapping include independent comparison of recorded cash receipts with funds actually deposited, separation of incoming receipts from subsidiary accounts receivable remittance advices, comparison of the details of bank deposits and the details of remittance credits, provision of timely statements, and confirmation of customer balances. One of the best methods to guard against lapping is use of a "lock box" system. In this system, customers send their payments directly to the bank, which prevents company employees from having access to payments received.

An effective method to detect lapping is to compare the dollar amounts and dates on the bank deposit slips with customer remittance credits recorded in the accounts receivable ledger. Any lapping not using exact replacement dates and amounts would be detected.

2. **Kiting**

Kiting occurs when a check drawn on one bank is deposited in another bank and no record is made of the disbursement in the balance of the first bank. Kiting may be used to cover a cash shortage or to pad a company's cash position.

Cash is recorded at 2 places at once

a. **How to Detect Kiting**

To detect kiting effectively, the cash deposits in transit at the end of a period and the paid checks returned with the bank statements of the next period must be examined. This is accomplished by preparing a bank transfer schedule. A bank transfer schedule compares the dates checks are drawn (on the disbursing bank account) to the dates checks are deposited (in the receiving bank account). Kiting is indicated when the date stamped by the receiving bank on the rear of the returned (paid) check precedes the date on which the disbursement was recorded.

## B. Internal Control

Control procedures and tests of controls related to cash receipts and cash disbursements were covered above in the discussions of the revenue cycle and the expenditure cycle. Segregation of duties is a key control over cash. Proper segregation of duties demands that close consideration be given to check-writing authority. Separation of cash handling, record keeping, and reconciliation of bank statements should exist, as well as separation of petty cash activities. Good internal control for cash would include the use of a voucher system for cash disbursements.

## C. Substantive Procedures Related to Cash

Balances

### 1. Auditing the Ending Cash Balance

#### a. Completeness, Valuation and Allocation, Existence

The primary audit procedures performed to test the existence, completeness and valuation of the ending cash balance are the bank confirmation and the audit of the year-end bank reconciliation.

**(1) Bank Confirmation**

The standard bank confirmation should be sent to all banks with whom the client has done business during the year, regardless of whether there is a year-end balance to confirm. This is done because the bank confirmation, in addition to verifying year-end balances, also provides evidence about actual loans and contingent liabilities, discounted notes, pledged collateral, and guarantee or security agreements. A sample bank confirmation is shown below.

**(2) Bank Reconciliation**

The year-end bank reconciliation for every account should be tested by:

(a) Footing the bank reconciliation and the list of outstanding checks.

(b) Agreeing the balance per the books to the general ledger.

(c) Agreeing the balance per the bank confirmation to the balance per the bank on the bank reconciliation.

(d) Agreeing deposits in transit and outstanding checks to the cutoff bank statement. The cutoff bank statement is obtained by the auditor from the bank and covers the first ten to fifteen days of the period after year-end. Reconciling items should generally clear during the ten to fifteen day period. Any item that does not clear should be investigated.

Transactions

### 2. Auditing Cash Receipts and Cash Disbursements

The following tests of details are generally performed as dual-purpose tests.

#### a. Completeness

For cash receipts, the auditor should *trace* a sample of remittance advices to the cash receipts journal and deposit slips. For cash disbursements, the auditor should *trace* a sample of cancelled checks to the cash disbursements journal.

b. **Cutoff**

The auditor should verify the cutoff of cash receipts and cash disbursements shortly before and after year-end for recording in the proper period. The auditor should also compare the dates for recording a sample of cash receipts with the dates the cash was deposited in the bank, and the dates for recording a sample of checks with the dates the checks cleared the bank, noting any significant delays.

c. **Valuation, Allocation, and Accuracy**

For cash receipts, from a sample of daily deposits, the auditor should foot the remittance advices and entries on the deposit slip and agree to the cash receipts journal and bank statement. For cash disbursements, from a sample of voucher packages, the auditor should agree the purchase order, receiving report, invoice, cancelled check, and disbursement journal.

d. **Existence and Occurrence**

For cash receipts, the auditor should *vouch* a sample of entries in the cash receipts journal to remittance advices, deposit slips, and the bank statement. For cash disbursements, the auditor should *vouch* a sample of entries from the cash disbursements journal to canceled checks, the voucher package, and the bank statement.

e. **Understandability and Classification**

The auditor should examine a sample of remittance advices and canceled checks for recording in the proper account.

Disclosures 3. **Auditing Presentation and Disclosure**

a. **Completeness**

The auditor should ensure that all required disclosures related to cash have been included in the notes to the financial statements. Required disclosures related to cash include:

(1) Policy defining cash and cash equivalents.

(2) Restrictions on cash, including sinking fund requirements.

(3) Compensating balance requirements.

b. **Valuation, Allocation, and Accuracy**

The auditor should read the footnotes and other information related to cash to determine whether the information is accurate and presented at the appropriate amounts.

c. **Rights and Obligations and Occurrence**

The auditor should compare disclosures to other audit evidence to ensure that all disclosed information related to cash has occurred.

d. **Understandability and Classification**

The auditor should read all cash related disclosures to ensure that they are understandable.

## D. Sample Confirmation Form

HW

### STANDARD FORM TO CONFIRM ACCOUNT BALANCE INFORMATION WITH FINANCIAL INSTITUTIONS

ORIGINAL
To be mailed to accountant

CUSTOMER NAME

**Financial Institution's Name and Address** [ ]
[ ]

We have provided to our accountants the following information as of the close of business on ________________, 20 _______, regarding our deposit and loan balances. Please confirm the accuracy of the information, noting any exceptions to the information provided. If the balances have been left blank, please complete this form by furnishing the balance in the appropriate space below.* Although we do not request nor expect you to conduct a comprehensive, detailed search of your records, if during the process of completing this confirmation additional information about other deposit and loan accounts we may have with you comes to your attention, please include such information below. Please use the enclosed envelope to return the form directly to our accountants.

1. At the close of business on the date listed above, our records indicated the following deposit balance(s):

| ACCOUNT NAME | ACCOUNT NO. | INTEREST RATE | BALANCE* |
|---|---|---|---|
| | | | |

2. We were directly liable to the financial institution for loans at the close of business on the date listed above as follows:

| ACCOUNT NO./ DESCRIPTION | BALANCE* | DATE DUE | INTEREST RATE | DATE THROUGH WHICH INTEREST IS PAID | DESCRIPTION OF COLLATERAL |
|---|---|---|---|---|---|
| | | | | | |

(Customer's Authorized Signature) (Date)

The information presented above by the customer is in agreement with our records. Although we have not conducted a comprehensive, detailed search of our records, no other deposit or loan accounts have come to our attention except as noted below.

(Financial Institution Authorized Signature) (Date)

(Title)

| EXCEPTIONS AND/OR COMMENTS |
|---|
| |

Please return this form directly to our accountants: [ ]
[ ]

* Ordinarily, balances are intentionally left blank if they are not available at the time the form is prepared.

Approved 1990 by American Bankers Association, American Institute of Certified Public Accountants, and Bank Administration Institute. Additional forms available from: AICPA – Order Department, P.O. Box 1003, NY, NY 10108-1003 D 451 5951

Inventory — Overstatement — Vouch
Reconcile
COGS — Understatement — Trace

Inventory

# V. INVENTORY CYCLE

## A. Internal Control

Internal control over inventory purchases and sales was covered in the sections on the revenue cycle and expenditure cycle. For inventory held by the entity, proper internal control includes adequate safeguarding of inventory and proper segregation of duties.

The following duties should be segregated:

1. **Purchasing**

   Serially numbered, properly approved purchase orders should be prepared and issued to the accounting and receiving departments.

2. **Receiving**

   The receiving department is solely responsible for the receipt of goods. This department is responsible for verification of quantities received, detection of damaged goods, preparation of a receiving report, and delivery of goods received to the warehouse department. The receiving department should receive a copy of the purchase order with the amounts blackened out.

3. **Warehouse**

   This department acts as custodian for the verified quantity of goods received.

4. **Shipping**

   The shipping department is responsible for shipment of goods after authorization (in the form of an approved sales order from the credit department).

Balance

## B. Substantive Procedures Related to Inventory

1. **Auditing the Ending Inventory Balance** *(inventory observation)*

   The observation of the beginning and ending physical inventory counts is a required generally accepted auditing procedure. Attendance at the physical inventory count involves the following dual-purpose tests:

   (i) inspecting the inventory to ascertain its existence and condition;

   (ii) performing test counts;

   (iii) evaluating management's instructions and procedures for the inventory count; and

   (iv) observing the performance of management's count procedures.

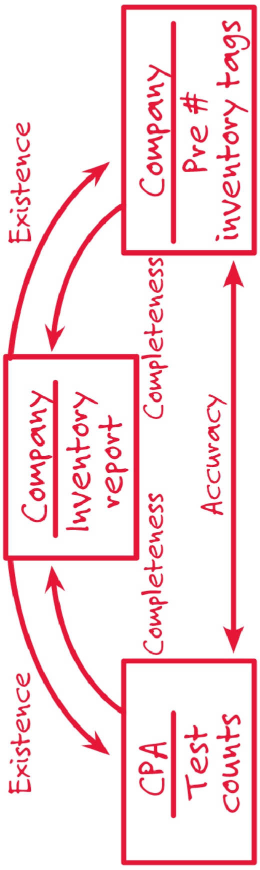
   An auditor who is not present to observe the physical inventory must use alternative procedures to justify any opinion expressed. This is acceptable when it is impractical or impossible to observe physical inventory, or when inventories are not material.

   An auditor's observation procedures with respect to well-kept perpetual inventories that are periodically checked by physical counts may be performed before, during, or after the end of the audit period. If inventory counting is done at a date other than the date of the financial statements, the auditor should obtain evidence about whether changes in inventory between the count date and the financial statement date are recorded properly. If the assessed level of control risk is high, the observation procedures should be performed at year-end.

   The auditor should observe the physical inventory count of goods held in public warehouses if the inventory held therein is significant; otherwise, confirmation of such inventory is sufficient.

**PASS KEY**

Candidates sometimes believe that "inventory observation" implies that the auditor counts the client's inventory. This is not the case—the client counts the inventory, and the auditor simply observes. The auditor may make test counts of certain items, but generally the auditor would not count the client's entire inventory.




a. **Completeness**

In conjunction with the inventory observation, the auditor should test the physical inventory report by *tracing* test counts to the report, thereby verifying its completeness. The auditor should also *trace* from a sample of prenumbered inventory tags to the physical inventory report sheets to test the completeness of the inventory report sheets.

b. **Valuation, Allocation, and Accuracy**

The auditor should perform the following procedures:

(1) Test the mathematical accuracy of the inventory report and reconcile it to the general ledger inventory accounts.

(2) Inquire about obsolete or damaged goods, scan the perpetual records for slow-moving items, and be alert during the inventory observation for damaged goods or signs of obsolescence.

(3) Examine vendor invoices, review direct labor rates, test the computation of standard overhead rates, and examine standard cost variance analyses.

(4) Perform inventory price tests for a sample of inventory items to determine whether the inventory is valued appropriately.

c. **Existence and Occurrence**

The primary purpose of the observation of the client's inventory count is to establish the existence of inventory. During the observation, the auditor should verify the existence of a sample of items in the physical inventory report by locating and performing test counts of the items. The auditor should also test the existence of the items on the client's inventory report sheets by *vouching* a sample of items from the inventory report sheet to the corresponding prenumbered inventory tags.

d. **Rights and Obligations**

The auditor should ascertain that consigned inventory on hand is excluded from the physical inventory count, whereas consigned goods in the hands of consignees are included in inventory balances.

Transactions **2. Auditing Inventory Transactions**

Inventory purchases and sales should be audited as part of the audits of the revenue cycle and the expenditure cycle, as described previously.

Disclosures **3. Auditing Presentation and Disclosure**

a. **Completeness**

The auditor should ensure that all required disclosures related to inventory have been included in the notes to the financial statements. Inventory disclosures include:

(1) Cost method (LIFO, FIFO, weighted average) and valuation method (net realizable value or lower of cost or market).

(2) Raw materials, work-in-process, and finished goods inventory balances.

(3) Consigned inventory.

(4) Pledged or assigned inventory.

(5) Significant losses from inventory write-downs or purchase commitments.

(6) Warranty obligations.

**b. Valuation, Allocation, and Accuracy**

The auditor should read the footnotes and other information related to inventory to determine whether the information is accurate and presented at the appropriate amounts.

**c. Rights and Obligations and Occurrence**

The auditor should determine that inventory-related obligations have been properly disclosed by inquiring of management and reviewing loan agreements and minutes for evidence that inventory has been pledged or assigned. The auditor should also inquire about warranty obligations. The auditor should compare disclosures to other audit evidence to ensure that all disclosed information related to inventory has occurred.

**d. Understandability and Classification**

The auditor should read all inventory related disclosures to ensure that they are understandable. The auditor should review inventory records for proper classification between raw materials, work in process, and finished goods.

Risk: overstatement [ Assets / Income ]
Vouch

## VI. INVESTMENT CYCLE

Investments

Sufficient audit evidence must be obtained by the auditor for investments in debt and securities. These types of investments may be in the form of debt and equity investments, derivative investments, and loan and advance accounts.

### A. Internal Control - ARC

Internal control over investments requires strong segregation of duties. One person (or, more commonly, the board of directors) should authorize the purchase or sale, another person should act as custodian (preferably an independent third-party custodian, who has no direct contact with entity employees, or joint control by two company officials), and a third person should maintain the detailed record of investments.

Investments not held by an independent third party custodian should be kept in a safe deposit box. The internal auditor or some other party not otherwise associated with investments should periodically count the investments in the safe deposit box and reconcile the securities counted with the investment subsidiary ledger.

### B. Substantive Procedures Related to Investments

Substantive tests of details related to the investment cycle generally focus on the ending balance in the investment accounts and presentation and disclosure. Analytical procedures are used to test the reasonableness of related gains and losses and investment income.

Balances

**1. Auditing the Ending Investment Balances**

**a. Completeness**

If the entity has a high volume of material investment transactions, the auditor should search for unrecorded purchases of securities by examining transactions for a few days after year-end. The auditor should also confirm securities held by the third party custodian or count securities on hand to determine that all securities have been recorded, although these are primarily tests of existence.

b. **Valuation and Allocation**

The auditor should perform the following procedures:

Reconcile & recalculate
Interest & dividends

(1) Obtain and foot a listing of investments by category (trading, available for sale, held-to-maturity, derivative, and equity method) and agree the totals to the general ledger.

(2) Obtain evidence corroborating the quoted year-end fair value by comparing assigned values to prices published by various sources or obtained from a third party, such as an independent broker-dealer or appraiser.

(3) Recalculate the ending values of investments not reported at fair value, including investments classified as held-to-maturity and accounted for using the equity method.

(4) Determine whether there has been any permanent impairment in the value of individual securities.

(5) Assess the reasonableness and appropriateness of assumptions, market variables, and valuation models, and of any decline in fair value.

c. **Existence**

(1) **Confirmation** - Also rights

Confirmations should be requested from the custodian for securities that are in the possession of third parties. It is also advisable to send confirmations to the broker-dealer and to counterparties concerning any unsettled transactions.

(2) **Examination of Securities on Hand**

An examination of the securities on hand should be made to coincide with the examinations of other liquid assets, such as cash. This procedure prevents the concealment of theft by making it impossible for one asset to serve as a substitute for another (i.e., to conceal a stolen asset). The face of the instrument should be examined to determine if ownership is correctly recorded. The auditor should record the details of the security count on a worksheet, which should also include an acknowledgement by the client that the securities were returned intact. If a safe-deposit box is used, the securities should be counted on the balance sheet date, or the bank should be requested to seal the box until the count is later completed.

d. **Rights and Obligations**

The confirmation of securities and the count of securities on hand provide evidence of the entity's ownership of investments. Additionally, the auditor may examine broker's advices for a sample of securities purchased during the year to verify the entity's ownership.

Transactions **2. Auditing Investment Transactions**

a. **Completeness**

The auditor should perform analytical procedures testing the reasonableness of dividend and interest income to determine that all investment income has been recorded.

b. **Cutoff**

A cutoff review should be performed to ensure that purchases, sales, and investment income were recorded in the proper period.

c. **Valuation, Allocation, and Accuracy**

Independent calculations should be made to determine the validity of recorded gains or losses from security sales and of discount and premium amortization. In addition, a recalculation should be made to determine the accuracy of recorded dividend and interest income. Investment income from dividends may be recalculated by comparing recorded income with dividend records produced by investment advisory services such as Moody's.

d. **Existence and Occurrence**

The analytical procedures performed to test the reasonableness of dividend and interest income provide evidence of the existence of investment income.

e. **Understandability and Classification**

The auditor should examine a sample of investment transactions to determine that the transactions were recorded in the proper accounts. For example, unrealized gains and losses on available-for-sale securities should be recorded in other comprehensive income, while unrealized gains and losses on trading securities should be recorded in earnings.

Disclosures 3. **Auditing Presentation and Disclosure**

a. **Completeness**

The auditor should ensure that all required disclosures related to investments have been included in the notes to the financial statements. Specifically, the auditor should determine whether all required marketable security and derivative disclosures have been made.

b. **Valuation, Allocation, and Accuracy**

The auditor should read the footnotes and other information related to investments to determine whether the information is accurate and presented at the appropriate amounts.

c. **Rights and Obligations and Occurrence**

The auditor should inquire of management and review loan agreements, minutes, and other documents to determine whether investments have been pledged as collateral. The auditor should compare disclosures to other audit evidence to ensure that all disclosed information related to investments has occurred.

d. **Understandability and Classification**

The auditor should read required disclosures for understandability, and review and evaluate the methods used to account for, classify, and value securities.

(1) **Marketable Securities**

Trading and available-for-sale securities over which the investor has no significant influence should be carried at fair value, and held-to-maturity debt securities should be carried at amortized cost. The auditor should inquire of management and obtain written representation concerning management's intent and ability with respect to holding versus selling securities in the near term.

(2) **Equity Method Investments**

For investments using the equity method, the auditor should examine the audited financial statements of the investee. The auditor should inquire of management regarding the entity's ability to exercise significant influence over investments to determine whether investments have been properly classified.

(3) **Derivatives**

An entity may invest in derivatives to hedge against risks, such as the risk associated with fluctuating prices. Under these circumstances, generally accepted accounting principles specify that, in order to qualify for hedge treatment, the entity must demonstrate and disclose a number of transaction features, including risk exposure. The auditor would therefore need to examine the contracts to evaluate the character of the hedge and the degree to which losses should be recognized in the determination of income, as well as to determine the appropriate character of any disclosures.

### C. Auditing Investments in Securities When Valuations Are Based on the Investee's Financial Results

When investments in securities are valued based on an investee's financial statements, the auditor should perform the following procedures to obtain sufficient appropriate audit evidence in support of the investee's financial results:

1. Obtain and read the financial statements and audit report of the investee.
2. If the financial statements are not audited or the audit report is not satisfactory, request that the entity arrange with the investee to have the financial statements audited.
3. If the carrying amount of the investment reflects factors that are not recognized in the investee's financial statements or fair values that are materially different from the investee's carrying amounts, obtain sufficient appropriate evidence in support of such amounts.
4. If the difference between the financial statement periods of the entity and the investee could have a material effect on the entity's financial statements, determine whether management has considered the lack of comparability and determine the effect, if any, on the auditor's report.

### D. Investments in Derivatives and Securities Measured or Disclosed at Fair Value

When auditing investments in derivatives and other securities measured or disclosed at fair value, the auditor should:

1. determine whether the applicable financial reporting framework specifies the method to be used to determine fair value;
2. evaluate whether the determination of fair value is consistent with the specified valuation method; and
3. if the fair value estimate is obtained from broker-dealers or other third-party sources, obtain an understanding of the method used to develop their fair value estimate.

Audit risk: overstatement
↓ouch

## VII. PROPERTY, PLANT, AND EQUIPMENT CYCLE

**Property, Plant, and Equipment**

Property, plant, and equipment includes all tangible assets with service lives greater than one year that are used in the operation of a business. The major transactions associated with these assets are purchases, repairs and maintenance, depreciation, disposal, revaluation (International Financial Reporting Standards [IFRS] only—see the Financial 4 lecture) and leasing.

### A. Internal Control

The internal control for property, plant, and equipment includes the controls in both the revenue and expenditure cycles as well as the following special controls:

1. **Acquisition**

   A special requisition form is generated for acquisitions. This form includes a description, reason for acquisition, amount to be charged, and probable cost, and it should be approved by top management. Acquisitions are tied to the capital budget, which the board of directors usually approves. Variances from this budget should be promptly investigated. The board of directors should also approve acquisitions of assets over a certain amount, regardless of whether these assets are purchased or constructed.

   The auditor should ascertain that company policy was followed and that fixed asset purchases were properly authorized.

2. **Subsidiary Ledgers**

   Detailed information concerning each asset is kept in the subsidiary ledger. Usually such information as the asset's description, identification number, location, acquisition date, cost, depreciation method, and amount of depreciation can be found in this ledger.

3. **Physical Security**

   Fixed assets should have identification plates. The serial number on the plate should be listed in the control account. Physical controls to safeguard assets from theft, destruction, or unauthorized disposition should also be in place, including periodic physical inspection of plant and equipment.

   Comparison of the serial number on the identification plate to that listed in the control account should be made. The auditor should also determine whether there are appropriate controls in place to safeguard fixed assets and prevent theft or destruction.

4. **Written Policies**

   Written depreciation policies and records should be maintained. Specific capitalization policies are also necessary to prevent misstatement of revenue and expenses.

5. **Disposition**

   Retirements of assets should be documented on a sequentially numbered work order containing evidence of proper authorization and the reason for retirement. This asset retirement order form is the basis for recording any cash received and for removing the asset and its accumulated depreciation from the subsidiary ledger. There should be a proper segregation of duties between authorization and custody (i.e., those who authorize a disposal should not be permitted to actually dispose of the asset).

**B. Substantive Procedures Related to Property, Plant, and Equipment**

Balance **1. Auditing the Ending Property, Plant, and Equipment Balance**

   **a. Completeness**

   The auditor should obtain and foot the fixed asset schedule and agree the total to the general ledger, obtain and foot a schedule of additions and dispositions of fixed assets and agree amounts to the fixed asset schedule, and select a sample of actual fixed assets and *trace* to the fixed assets subsidiary ledger.

① Co. does not/cannot insure an asset they don't have
② Co. does not pay taxes on unowned property
③ Tour plant/inquire



b. **Valuation and Allocation**

The auditor should recalculate accumulated depreciation for reasonableness. The auditor should also evaluate fixed assets for impairment by examining the entity's documented impairment analysis, identifying circumstances that could indicate that the book value of fixed assets is not recoverable, and reperforming the entity's impairment analysis to determine whether recorded impairment losses are reasonable. If the entity uses IFRS, the auditor should verify the reasonableness of any fixed asset revaluations.

c. **Existence**

The auditor should *vouch* additions to the fixed asset accounts by examining internal documents (such as the asset requisition form), by examining external evidence (such as invoices), and by inspecting the actual asset. The auditor should also consider selecting older fixed assets from the subsidiary ledgers and then trying to locate those assets, as a means of testing for unrecorded retirements.

d. **Rights and Obligations**

The auditor should examine invoices, deeds, and title documents to confirm ownership of fixed assets.

Transactions 2. **Auditing Property, Plant, and Equipment Transactions**

The following tests of details can be performed as dual-purpose tests.

a. **Completeness**

*Trace* a sample of fixed asset purchase requisitions to receiving reports and the fixed asset subsidiary ledger. The auditor should also review the related repair and maintenance expense accounts to test for completeness of asset additions. The auditor is looking for items recorded as repairs that should have been capitalized.

**PASS KEY**

The examiners sometimes try to trick the candidates with questions about the repairs and maintenance account. Keep in mind that the auditor often reviews this account in order to locate items that should have been capitalized.

b. **Cutoff**

Review fixed asset purchases and dispositions from shortly before and after year-end for recording in the proper period.

c. **Valuation, Allocation, and Accuracy**

Depreciation expense should be recalculated for reasonableness and conformity with GAAP. Gains and losses and the charge-off of accumulated depreciation for fixed assets sold or retired should be tested for reasonableness. Revaluation losses and surplus should be recalculated.

d. **Existence and Occurrence**

The auditor should *vouch* a sample of purchases to the receiving report and vendor invoice and a sample of dispositions to the asset retirement form and other supporting documentation.

e. **Understandability and Classification**

The auditor should examine a sample of significant charges to repairs and maintenance expense for items that should have been capitalized (also a completeness test) and should review lease transactions for proper classification as operating or capital.

Disclosures

3. **Auditing Presentation and Disclosure**

a. **Completeness**

The auditor should ensure that all required disclosures related to fixed assets have been included in the notes to the financial statements. Required disclosures include:

(1) Depreciation methods and useful lives.

(2) Depreciation expense for the period.

(3) Balance of each class of capital assets by nature or function.

(4) Accumulated depreciation allowances by class or in total.

(5) Liens and mortgages.

(6) Capital and operating lease information.

b. **Valuation, Allocation, and Accuracy**

The auditor should read the footnotes and other information related to fixed assets to determine whether the information is accurate and presented at the appropriate amounts.

c. **Rights and Obligations and Occurrence**

The auditor should inquire of management and review loan agreements, minutes and other documents to determine whether fixed assets have been pledged as collateral. The auditor should compare disclosures to other audit evidence to ensure that all disclosed information related to fixed assets has occurred.

d. **Understandability and Classification**

The auditor should also read required disclosures for understandability.

Audit risk: understatement [ Expenses / Liabilities

↑race

## VIII. PAYROLL AND PERSONNEL CYCLE

Payroll

### A. Internal Control

The most significant payroll and personnel cycle risks are the creation of fictitious employees and the falsification of hours worked.

1. **Service Organizations**

A3 ← As discussed in Auditing 3, many entities use service organizations to process payroll transactions. The service organization's services are considered to be part of a user entity's information system when those services affect the initiation, execution, processing, or reporting of the user company's transactions. In such cases, the controls placed in operation by the service organization are considered to be part of the user organization's information system.

2. **Segregation of Duties**

Even when a service organization is used, there should be a proper segregation of duties, as follows:

ARC a. **Authorization to Employ and Pay**

It is the function of the human resources department to hire new employees (on the basis of requisitions from user departments) and to maintain the personnel records containing hire date, department, salary, and position.

ARC b. **Supervision**

All pay base data (hours, absences, time off, etc.) should be approved by an employee's immediate supervisor.

ARC c. **Timekeeping and Cost Accounting**

Data on which pay is based, such as hours worked or jobs completed, should be accumulated independent of any other function.

Where there are employees who are paid by the hour, it is advisable to use time clocks. Each department supervisor should compare the job time tickets with employee clock cards that have been signed by the employee. Salaried employees should prepare time sheets, which also require supervisory approval.

ARC d. **Payroll Check Preparation**

The payroll department computes salary based on information received, for example, total hours worked for hourly employees. If a service organization is not used, this department is responsible for issuing the unsigned payroll checks that are later signed by the treasurer or the CFO. If a check signature plate is used to sign the payroll checks, the treasurer or CFO should supervise this process. There should be controls over access to blank checks and check signature plates.

**PASS KEY**

Remember that the payroll department is a record keeping department, not a custodial department. While employees in this department compute salaries, create the payroll register, and prepare unsigned checks, they should neither have the authority to initiate changes in hours or rates, nor should they have the ability to sign checks.

ARC e. **Check Distribution**

In many companies, payroll checks are deposited directly into employees' bank accounts. If paychecks are manually distributed, then the payroll checks should be distributed by a person who has no other payroll function. In larger corporations, this individual is often referred to as the paymaster.

The employees should be required to show some form of identification before receiving their paychecks. Unclaimed payroll checks should be investigated by an independent party.

The internal auditing department periodically compares the personnel files with the payroll files. This is to help ensure that only authorized payments have been made in the proper amounts to appropriate personnel.

3. **Internal Control Evaluation**

The auditor should evaluate whether internal controls provide reasonable assurance that only valid employees are being paid, that payment is for the actual hours worked, and that the correct rate of pay is used. The following procedures should be performed:

a. Observe segregation of duties between human resource responsibilities and payroll distribution.

b. Compare the personnel records for each department with the actual time cards and the employees actually working in each department.

c. Observe payroll distribution on an unannounced basis to ensure that all personnel being paid are actually employed by the company.

d. Observe the use of time clocks and investigate time cards not used.

e. Test transfers and underlying employee authorizations if direct deposit is used.

f. Test general and application controls to ensure that payroll transactions are valid, properly authorized, and completely and accurately recorded. For example, hours worked should be compared to predetermined minimums and maximums (a range test), or to prior periods (a reasonableness test).

## B. Substantive Procedures Related to Payroll and Personnel

Balances 1. **Auditing the Payroll Accrual**

When internal control over payroll is effective, the auditor generally focuses substantive procedures on analytical procedures and the recalculation of payroll accruals (valuation assertion). Tests related to completeness, existence and rights and obligations are generally performed only when the entity's internal control over payroll cannot be relied upon.

**a. Completeness**

The auditor should test the completeness of the payroll accrual when performing the search for unrecorded liabilities.

**b. Valuation and Allocation**

The auditor should recalculate any year-end payroll accrual and compare the calculated amount to the reported accrual.

**c. Existence**

The auditor should *vouch* amounts from the client's calculation of the payroll accrual to supporting documentation.

**d. Rights and Obligations**

The auditor should examine supporting documentation to verify that the payroll accrual is an obligation of the entity.

Transactions 2. **Auditing Payroll Transactions**

The following tests of details can be performed as dual-purpose tests.

**a. Completeness**

*Trace* a sample of timecards to the payroll register.

**b. Cutoff**

Examine a sample of timecards from before and after year-end to the payroll report to determine whether the transactions were recorded in the proper period.

c. **Valuation, Allocation, and Accuracy**

The auditor should test the accuracy and valuation of payroll expense by performing the following procedures:

(1) Compare total recorded payroll with total payroll checks issued.

(2) Test extensions and footings of payroll.

(3) Verify pay rates and payroll deductions with employee records from personnel.

(4) Recalculate gross and net pay on a test basis.

(5) Compare payroll costs with standards or budgets.

(6) Recompute the mathematical accuracy of a sample of paychecks.

d. **Existence and Occurrence**

*Vouch* time on payroll summaries by selecting a sample of payroll register entries and comparing to time cards and approved time reports. From a sample of payroll transactions, the auditor should find the related employee to verify the existence and current employment status.

e. **Understandability and Classification**

The auditor should examine a sample of paychecks for classification into the proper expense accounts.

Disclosures

3. **Auditing Presentation and Disclosure**

a. **Completeness**

The auditor should ensure that all required disclosures related to payroll have been included in the notes to the financial statements. Required disclosures include:

(1) Pension and postretirement benefit disclosures.

(2) Stock-based compensation disclosures.

(3) Deferred compensation and profit-sharing plans.

b. **Valuation, Allocation, and Accuracy**

The auditor should read the footnotes and other information related to payroll to determine whether the information is accurate and presented at the appropriate amounts.

c. **Rights and Obligations and Occurrence**

The auditor should inquire about accruals for proper disclosure. The auditor should compare disclosures to other audit evidence to ensure that all disclosed information related to payroll has occurred.

d. **Understandability and Classification**

The auditor should also read required disclosures for understandability.

Audit risk: understatement Liabilities/expenses ↑ Trace

## IX. FINANCING CYCLE

The financing cycle includes an entity's debt and equity.

### A. Internal Control Over Debt

An entity's internal control over debt should include the following:

1. Adequate documentation of all financing agreements.
2. Authorization of new debt financing by the board of directors or management.
3. Detailed records of long-term debt, including interest and principal payments and the amortization of bond premiums and discounts.

B of D minutes

### B. Internal Control Over Equity

All stock issuances, dividend declarations, and treasury stock purchases must be authorized by the board of directors. Evidence of these events should be duly recorded in the minutes of board meetings.

Many large entities use a stock transfer agent who ensures that stock issuances comply with the articles of incorporation, prepares stock certificates, and maintains records of shares authorized, issued, and outstanding. If a stock transfer agent is not used, then the entity should implement the following controls:

1. An officer of the entity should be responsible for ensuring that stock transactions comply with the articles of incorporation and regulatory requirements and should maintain the stock certificate book. To ensure proper segregation of duties, the individual who maintains the stock certificate book should have no accounting responsibilities.
2. There should be a periodic independent reconciliation of the stock certificate book with the number of shares outstanding.

Balances

### C. Substantive Procedures Related to Debt

#### 1. Auditing the Ending Debt Balance

**a. Completeness**

The auditor should review board minutes for evidence of new debt, obtain new debt agreements, and *trace* all new debt contracts to the financial statements. The auditor should obtain a listing of all debt and agree the total to the general ledger. Any debt disclosed on the standard bank confirmation should be *traced* to the debt agreements and the financial statements. Notes and bonds should be confirmed directly with creditors. The auditor should inquire of management regarding new debt and any off-balance sheet financing transactions.

**b. Valuation and Allocation**

The auditor should examine new debt agreements to determine whether they were recorded at the proper amount. The auditor should recompute any interest payable and recompute the amortization of premiums or discounts.

**c. Existence**

The auditor should confirm notes or bonds directly with creditors.

**d. Rights and Obligations**

The auditor should examine note and bond agreements to verify that they are the obligations of the entity.

Transactions **2. Auditing Debt Transactions**

The following tests of details can be performed as dual-purpose tests.

**a. Completeness**

The auditor should examine new debt agreements and the board minutes for evidence of new agreements. The auditor should review interest expense for payments to debt holders not included in the debt listing. The auditor should examine lease agreements for proper classification as operating or capital.

**b. Cutoff**

The auditor should review debt activity shortly before and after year-end to ensure that transactions were reported in the proper period.

**c. Valuation, Allocation, and Accuracy**

The auditor should test a sample of debt receipts and payments and should compare interest expense to the debt balance for reasonableness.

**d. Existence and Occurrence**

The auditor should verify the existence of new debt by reviewing the board minutes for evidence of new agreements and then inspecting the agreements.

**e. Understandability and Classification**

The auditor should examine the due dates of notes and bonds to determine whether the debt should be classified as short-term or long-term.

Disclosures **3. Auditing Presentation and Disclosure**

**a. Completeness**

The auditor should ensure that all required disclosures related to debt have been included in the notes to the financial statements. Required disclosures include:

(1) Details of maturity dates, interest rates, call and conversion privileges, and assets pledged as collateral.

(2) Future sinking fund payments and maturities for each of the next five years.

(3) Restrictive loan covenants.

**b. Valuation, Allocation, and Accuracy**

The auditor should read the footnotes and other information related to debt to determine whether the information is accurate and presented at the appropriate amounts.

**c. Rights and Obligations and Occurrence**

The auditor should compare disclosures to other audit evidence to ensure that all disclosed information related to debt has occurred.

**d. Understandability and Classification**

The auditor should also read required disclosures for understandability.

## D. Substantive Procedures Related to Stockholders' Equity and Treasury Stock

When auditing equity, the auditor is primarily concerned about completeness, valuation, and existence and occurrence. The auditor should also focus on evaluating classification and understandability.

### 1. Completeness

If the client uses a stock transfer agent, third-party confirmations should be used to provide evidence of the completeness of shares authorized, issued, and outstanding, as well as to provide evidence of the individual transactions.

If a client does not use a stock transfer agent, the primary source of evidence of completeness is the stock certificate book. The auditor should examine the stock certificate stubs for proper recording, for any canceled certificates, and for the existence of the remaining unissued certificates. The auditor should foot the shares outstanding in the stock certificate book and agree the total to the general ledger. The auditor should examine all shares of treasury stock and agree the total to the general ledger.

The auditor should ensure that all required disclosures related to equity have been included in the notes to the financial statements. Required equity disclosures include:

a. Number of shares authorized, issued, and outstanding.

b. Rights and privileges of securities, including dividend and liquidation preferences, participation rights, call prices and dates, conversion or exercise prices or rates and pertinent dates, sinking-fund requirements, unusual voting rights, and significant contracts to issue additional shares.

c. Stock option plans.

d. Appropriations of retained earnings and restrictions on dividends.

### 2. Valuation

The auditor may recompute the value assigned to stock transactions during the period. The auditor should also analyze the retained earnings account from inception (or since the last audit) and should review the propriety of any direct entries to retained earnings.

### 3. Existence and Occurrence

Existence and occurrence can be tested by *vouching* transactions recorded during the current period to board minutes. The stock transfer agent confirmation and the inspection of the stock certificate book also provide evidence of existence.

### 4. Understandability and Classification

The auditor should determine whether there are restrictions on retained earnings resulting from loans, agreements, or state laws. The auditor should also inquire of management regarding any appropriations of retained earnings. Restrictions and appropriations must be properly disclosed.

# OTHER AUDIT PROCEDURES

## I. RELATED PARTY TRANSACTIONS

Audit risk:
accuracy and completeness

Related Parties

### A. Auditor's Responsibility

When auditors are performing an examination of financial statements, they are responsible for identifying any related party transactions encountered during the course of the audit and for determining whether the transactions have been properly accounted for and disclosed in the financial statements. An understanding of related party transactions and relationships is also relevant to the auditor's evaluation of fraud risk because fraud is more easily committed through related parties. *Related parties may include the reporting entity's affiliates, principal owners, management, and members of their immediate families.*

### B. Accounting for Related Party Transactions

Except for very routine transactions, it is virtually impossible to determine whether a transaction would have taken place in exactly the same manner if the parties weren't related. Therefore, a related party transaction is not considered to be an arm's-length transaction. For this reason, the substance of a related party transaction may be very different from its form, and GAAP requires that such transactions be disclosed.

### C. Audit Objectives

The auditor should obtain an understanding of related party relationships and transactions sufficient to:

1. Recognize fraud risk factors, if any, arising from related party relationships and transactions that are relevant to the assessment of the risk of material misstatement due to fraud.
2. Conclude whether the financial statements achieve fair presentation, insofar as they are affected by related party relationships.
3. Obtain sufficient appropriate audit evidence about whether related party transactions and relationships have been appropriately identified, accounted for, and disclosed.

### D. Determining the Existence of Related Parties

Application of specific procedures regarding material transactions with related parties may include:

1. *Evaluating* the company's controls related to the authorization and approval of significant related party transactions and the procedures for identifying, accounting for, and disclosing related party transactions. The auditor should obtain a conflict of interest statement from the client.
2. *Asking* management for the names of all related parties, including changes from the prior period, the nature of the relationships between the entity and related parties, whether the entity entered into any transactions with related parties, and the types and purposes of any related party transactions.
3. *Reviewing* the reporting entity's filings with the SEC and other regulatory agencies concerning the names of officers and directors who occupy management or directorship positions in other businesses.
4. *Reviewing* material transactions (especially investment transactions) for related party evidence, including bank and legal confirmations, minutes, and other appropriate records and documents.
5. *Reviewing* prior years' audit documentation or inquiring of the predecessor auditor.

**PCAOB STANDARDS—GUIDANCE FOR ISSUERS**

PCAOB guidance provides detailed procedures that should be performed to obtain an understanding of the company's relationships and transactions with its related parties, which include:

- obtaining an understanding of the company's process for identifying related parties, authorizing and approving transactions with related parties, and accounting for and disclosing relationships and transactions with related parties in the financial statements;
- performing inquiries (discussed below); and
- communicating with the audit engagement team and other auditors.

The auditor should inquire of management and others within the company who are likely to have knowledge of controls or transactions with related parties regarding:

- the names of the company's related parties during the period under audit, including changes from the prior period;
- background information concerning the related parties (e.g., physical location, industry, size, and extent of operations);
- the nature of any relationships, including ownership structure, between the company and its related parties;
- the transactions entered into, modified, or terminated, with its related parties during the period under audit and the terms and business purposes (or the lack thereof) of such transactions;
- the business purpose for entering into a transaction with a related party versus an unrelated party;
- any related party transactions that have not been authorized and approved in accordance with the company's established policies or procedures regarding the authorization and approval of transactions with related parties; and
- any related party transactions for which exceptions to the company's established policies or procedures were granted and the reasons for granting those exceptions.

The auditor should inquire of the audit committee or its chair, regarding:

- the audit committee's understanding of the company's relationships and transactions with related parties that are significant to the company; and
- whether any member of the audit committee has concerns regarding relationships or transactions with related parties and, if so, the substance of those concerns.

## E. Risk-Based Approach

The auditor should identify and assess the risks of material misstatement associated with related party transactions and determine whether any of those risks are significant risks. If the auditor identifies any fraud risk factors in connection with related parties, the auditor should consider this information when assessing the risks of material misstatement due to fraud. The auditor should design and perform further audit procedures to obtain sufficient appropriate audit evidence about the assessed risk of material misstatement associated with related party transactions.

## F. Identifying and Examining Related Party Transactions

### 1. Identifying Related Party Transactions

The auditor should discuss the entity's relationships and transactions with related parties with the engagement team and provide the names of known related parties to the audit staff. The auditor should remain alert for the following items, which may be indicative of a related party transaction.

a. Compensating balance arrangements (which may be maintained by or for related parties).

b. Loan guarantees.

c. Unusual, nonrecurring transactions near year-end.

d. Transactions based on terms that differ significantly from market terms.

e. Nonmonetary exchanges.

2. **Identified Significant Related Party Transactions**

When the auditor identifies significant related party transactions outside of the normal course of the entity's business, the auditor should:

a. Inspect the underlying contracts or agreements, if any, and evaluate whether:

(1) The business rationale of the transactions suggests that they may have been entered into to engage in fraud.

(2) The terms of the transactions are consistent with management's explanations.

(3) The transactions have been appropriately accounted for and disclosed.

b. Obtain audit evidence that the transactions have been appropriately authorized and approved.

**PCAOB STANDARDS—GUIDANCE FOR ISSUERS**

PCAOB guidance provides additional procedures that should be performed for each related party transaction that is either required to be disclosed in the financial statements or determined to be a significant risk:

- Determine whether any exceptions to the company's established policies or procedures were granted.
- Evaluate the financial capability of the related parties with respect to significant uncollected balances, loan commitments, supply arrangements, guarantees, and other obligations, if any.
- Perform procedures on intercompany account balances as of concurrent dates, even if fiscal years of the respective companies differ.

## G. Identification of Previously Unidentified or Undisclosed Related Parties or Significant Related Party Transactions

If the auditor identifies related parties or significant related party transactions that management has not previously identified or disclosed to the auditor, the auditor should:

1. Communicate the information to the other members of the engagement team.
2. Request management to identify all transactions with the newly identified related parties.
3. Inquire why the entity's controls failed to enable the identification and disclosure of the related party relationships or transactions.
4. Perform appropriate substantive procedures.
5. Reconsider the risk that other related parties or related party transactions may not have been identified or disclosed.
6. Evaluate the audit implications if management's nondisclosure appears intentional.

### H. Impact on the Auditor's Report

If management indicates in the financial statements that the transaction was consummated on arm's-length terms and the auditor believes this statement is unsubstantiated, the auditor should express a qualified or adverse opinion.

### I. Documentation

The auditor should include the names of all identified related parties and the nature of the related party relationships in the audit documentation.

## II. ACCOUNTING ESTIMATES - Management [ ① Responsible ② Subjective = Risk

### A. Defined

Estimates

An accounting estimate is an approximation of a financial statement element, item, or account. Estimates are used because either data about past events cannot be accumulated in a timely, cost-effective manner or because measurement of some accounts is dependent upon the outcome of future events. It is the responsibility of management to make reasonable estimates and include them in the financial statements.

Examples of estimates include:

1. net realizable values of inventory and accounts receivable;
2. compensation in stock option plans;
3. future pension and warranty expenses; and
4. probability of loss and related amounts due to litigation.

Examples
- FMV
- Impairment
- Revenue recognition

### B. Auditor's Responsibilities

The auditor has the following responsibilities when evaluating estimates:

1. Evaluate the degree of estimation uncertainty associated with an accounting estimate.
   a. *Estimation uncertainty* is the susceptibility of an accounting estimate to an inherent lack of precision in its measurement.
   b. The auditor should determine whether accounting estimates with high estimation uncertainty give rise to significant risks.
2. Assess management's written policies and practices regarding the development and use of estimates.
3. Verify that all material estimates have been developed.
4. Determine that the accounting estimates are reasonable. In evaluating reasonableness, the auditor focuses on assumptions that are significant to the estimate, sensitive to variations, deviations from historical patterns, or subjective and susceptible to misstatement or management bias.
5. Ensure that the accounting estimates are properly presented and disclosed in conformity with GAAP.

### C. Procedures

In evaluating the reasonableness of an estimate, the auditor must first obtain an understanding of how management developed its estimate. The auditor would then perform one or a combination of the following procedures:

1. Review and test the procedures used by management to develop the estimate.
2. Develop an independent estimate of the item for comparative purposes.
3. Review subsequent events and transactions (occurring prior to the date of the auditor's report) that corroborate the value of the estimate.

**PCAOB STANDARDS—GUIDANCE FOR ISSUERS**

PCAOB standards state that when an auditor determines that the amount of an accounting estimate included in the financial statements is unreasonable or was not determined in conformity with the requirements of the applicable financial reporting framework, then the auditor should treat as a misstatement the difference between the recorded estimate and the best estimate supported by the audit evidence. If the auditor determines a range of reasonable estimates, then the auditor should treat as a misstatement the difference between the recorded estimate and the closest reasonable estimate supported by the audit evidence.

The auditor should also evaluate whether the difference between the reported estimate and the best estimate supported by the audit evidence indicates possible management bias.

1 Consistent method with prior period
2 Past track record of estimates is accurate
3 Justify any changes in approach
4 Appropriate in relation to industry

## III. AUDITING FAIR VALUES

Fair Values

### A. Fair Value Reporting

Certain assets, liabilities, and specific components of equity are presented or disclosed at fair value in the financial statements.

1. Fair value is defined as the amount at which an asset could be sold (or the amount at which a liability could be settled) in a current transaction between willing parties.
   a. Market value (e.g., a published price quotation in an active market) should be used where possible. Level 1 (identical) & level 2 (similar)
   b. Estimates and valuation methods may be used when market values are not available. Level 3 (DCF)
2. Fair value measurements may arise from both the initial recording of a transaction and later changes in value.
   * a. Changes in fair value measurement may be treated in different ways under GAAP (e.g., included in net income, reflected in other comprehensive income and equity, etc.).

### B. Management's Responsibility

Management is responsible for making fair value measurements and disclosures in accordance with GAAP.

1. Where market prices are not available, appropriate valuation methods should be used to estimate fair value.
2. Valuation methods should incorporate assumptions that would be used in the market when possible.
3. Management should identify and support any significant assumptions used.

## C. Auditor's Responsibilities

1. The auditor should obtain sufficient appropriate audit evidence to provide reasonable assurance that fair value measurements and disclosures are in conformity with GAAP. The auditor should:

    a. Understand the entity's process for determining fair value measurements and disclosures.

    b. Understand relevant controls. - ARC

    c. Assess the risk of material misstatement of fair value measurements.

    d. Evaluate conformity with GAAP.

    e. Consider the need for a specialist.

    f. Test fair value measurements and disclosures (covered further below).

    g. Evaluate whether fair value disclosures are in conformity with GAAP.

    h. Evaluate the sufficiency, competency, and consistency of evidence obtained with respect to fair value measurements and disclosures.

    i. Obtain relevant management representations (e.g., relating to the reasonableness of significant assumptions, management's intent and ability to carry out planned courses of action, completeness and adequacy of disclosure, the effect of subsequent events, etc.).

    j. Communicate relevant matters to those charged with governance (e.g., matters related to particularly sensitive fair value estimates).

2. The auditor bases his or her evaluation on information available at the time of the audit, and is not responsible for predicting future conditions that, if known at the time of the audit, might have affected fair value measurements and disclosures.

## D. Testing Fair Value Measurements and Disclosures

In testing an entity's fair value measurements and disclosures, the auditor may:

1. Determine whether management's significant assumptions provide a reasonable basis for fair value measurements.
2. Consider management's intent and ability to carry out courses of action that may affect fair values.
3. Evaluate whether the valuation model is appropriate given the entity's circumstances.
4. Test the underlying data for accuracy, completeness, relevancy, and consistency.
5. Develop independent fair value estimates for corroborative purposes.
6. Review subsequent events and transactions (occurring before the date of the auditor's report) for evidence regarding fair value measurements at the balance sheet date.

**Contingencies**

Audit risk: Understatement

Expenses & liabilities

# IV. EVALUATING CONTINGENCIES

Litigation, claims & assessments

In performing an audit in accordance with generally accepted auditing standards, the independent auditor must obtain appropriate evidence regarding contingent liabilities. Contingent liabilities may arise from many sources, including:

(i) Pending and threatened litigation

(ii) Actual or possible claims and assessments

(iii) Guarantees of the indebtedness of others

(iv) Product warranties

(v) Income tax disputes

Under GAAP, contingent liabilities that are probable and can be reasonably estimated must be accrued and disclosed.

**A. Identifying Contingencies**

The auditor should ask management about contingent liabilities, including pending litigation or possible future litigation and about controls adopted to identify, evaluate, and account for such items. In conjunction with these inquiries, the auditor should perform the following procedures:

1. Review the minutes of meetings of stockholders, board of directors, and other executive committees.
2. Review correspondence and invoices from lawyers.
3. Review contracts, loan agreements, loan guarantees, leases, and correspondence from taxing authorities.
4. Review bank confirmations for hidden bank loans, discounted drafts, guarantee of notes, etc.
5. Discuss long-term purchase commitments with the purchasing agent.
6. Review the status of long-term leases.
7. Discuss sales contracts with the sales manager.
8. Review the interim financial statements after year-end.
9. Obtain a client representation letter.
10. Send an inquiry letter to the client's attorneys.

**B. Specific Inquiry Into Litigation, Claims and Assessments**

For actual or potential litigation, claims, and assessments, the auditor should obtain audit evidence relevant to:

1. the period in which the underlying cause for legal action occurred;
2. the degree of probability of an unfavorable outcome; and
3. the amount or range of potential loss.

> *Note:* It is management's responsibility to identify and account for contingent liabilities, including litigation, claims, and assessments, through the policies adopted by management for such purposes. The management representation letter should indicate that management has disclosed to the independent auditor all such relevant information.

**C. Letter of Inquiry to Client's Attorneys**

When audit procedures indicate that there are actual or potential litigation, claims, or assessments, the auditor should seek direct communication with the entity's external legal counsel through a letter of inquiry regarding litigation, claims and assessments. This letter is prepared by management and sent by the auditors to the attorneys. When in-house legal counsel has responsibility for litigation, claims, and assessment, the auditor should also seek direct communication with the in-house legal counsel through a letter of inquiry.

The auditor should document the basis for any decision not to seek direct communication with legal counsel.

1. **Response by Attorneys**

   The attorneys in turn send their replies directly to the independent auditor. In these replies, attorneys give their evaluation concerning litigation, claims and assessments within their knowledge or control. The date of the attorney's response should be as close as possible to the date of the auditor's report.

2. **Limitations on Response**

   The lawyer's response to the letter of inquiry should include a professional opinion on the expected outcome of any lawsuit and the likely outcome of any liability, including court costs.

   a. **"Substantial Attention" Limitation**

      Lawyers may limit their replies to matters to which they have given substantial attention. Responses may also be limited to material matters if an understanding has been reached between the lawyer and the auditor as to what amount would be considered material.

   b. **Confidentiality Limitation**

      In some cases, it may be unwise for a lawyer to disclose certain confidential information. An example of this may be knowledge of a patent violation, if the disclosure of the violation in the financial statements could bring about a lawsuit.

3. **Refusal to Respond** - Scope limitation [ Q D

   A lawyer's refusal to respond to a letter of inquiry where the lawyer has devoted substantial attention to litigation matters is a limitation in the scope of an independent auditor's examination, sufficient to preclude an unmodified opinion.

4. **Refusal to Permit Inquiry** [ D W

   A client's refusal to permit inquiry of the attorneys generally will result in a disclaimer of opinion or withdrawal from the audit.

5. **Inherent Uncertainties**

   In some cases, inherent uncertainties may make it difficult for a lawyer to form conclusions regarding pending litigation. If the auditor is satisfied that financial statement disclosure is adequate, no modification to the opinion would be required.

**PASS KEY**

Note that management is the primary source of information regarding contingencies, including litigation, claims, and assessments. The letter sent to the client's lawyer is simply a means of corroborating information provided by management.

## 6. Sample Letter of Audit Inquiry

HW

*[Company Letterhead]*

Gentlemen:

In connection with an audit of our financial statements at (balance sheet date) and for the (period) then ended, management of the Company has prepared, and furnished to our auditors (name and address of auditors), a description and evaluation of certain contingencies, including those set forth below involving matters with respect to which you have been engaged and to which you have devoted substantive attention on behalf of the Company in the form of legal consultation or representation. These contingencies are regarded by management of the Company as material for this purpose *(management may indicate a materiality limit if an understanding has been reached with the auditor)*. Your response should include matters that existed at (balance sheet date) and during the period from that date to the date of your response.

**Pending or Threatened Litigation**

*[Ordinarily management's information would include (i) the nature of the litigation, (ii) the progress of the case to date, (iii) how management is responding or intends to respond to the litigation, and (iv) an evaluation of the likelihood of an unfavorable outcome and an estimate, if one can be made, of the amount or range of potential loss.]*

This letter will serve as our consent for you to furnish to our auditor all the information requested therein. Accordingly, please furnish to our auditors such explanation, if any, that you consider necessary to supplement the foregoing information, including an explanation of those matters as to which your views may differ from those stated and an identification of the omission of any pending or threatened litigation, claims, and assessments or a statement that the list of such matters is complete.

**Unasserted Claims and Assessments**

*[Ordinarily management's information would include (i) the nature of the matter, (ii) how management intends to respond if the claim is asserted, and (iii) an evaluation of the likelihood of an unfavorable outcome and an estimate, if one can be made, of the amount or range of potential loss.]*

Please furnish to our auditors such explanation, if any, that you consider necessary to supplement the foregoing information, including an explanation of those matters as to which your views may differ from those stated.

We understand that whenever, in the course of performing legal services for us with respect to a matter recognized to involve an unasserted possible claim or assessment that may call for financial statement disclosure, if you have formed a professional conclusion that we should disclose or consider disclosure concerning such possible claim or assessment, as a matter of professional responsibility to us, you will so advise us and will consult with us concerning the question of such disclosure and the applicable requirements of Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 450, *Contingencies*. Please specifically confirm to our auditors that our understanding is correct.

Please specifically identify the nature of and reasons for any limitations on your response.

Very truly yours,

*[Name]*

# EVALUATING AUDIT FINDINGS

Overall Review

## I. ANALYTICAL PROCEDURES USED AS AN OVERALL REVIEW

Required

Analytical procedures are required during the overall review stage of an audit. Generally, a manager or partner who has a comprehensive knowledge of the client's business and industry reads the financial statements and disclosures and performs this review.

The purpose of applying analytical procedures during the overall review stage of an audit is to evaluate the overall financial statement presentation, to assess the conclusions reached, and to assist in forming an opinion on whether the financial statements as a whole are free of material misstatement. The auditor should determine whether adequate evidence has been gathered in response to unusual or unexpected balances identified during the audit. The auditor may also discover additional unusual or unexpected balances, transactions, events, or relationships, including fraud risks, during this overall review, and should consider whether additional audit procedures are warranted.

**PCAOB STANDARDS—GUIDANCE FOR ISSUERS**

PCAOB standards state that the nature and extent of the analytical procedures performed during the overall review may be similar to the analytical procedures performed as risk assessment procedures. The auditor should perform analytical procedures relating to revenue through the end of the reporting period.

## II. EVALUATE WHETHER THE FINANCIAL STATEMENTS ARE FREE OF MATERIAL MISSTATEMENT

The auditor must evaluate the audit evidence gathered to determine whether the financial statements are free of material misstatement due to error or fraud.

**PCAOB STANDARDS—GUIDANCE FOR ISSUERS**

PCAOB standards state that auditor's evaluation of audit results should include evaluation of the following:

- The results of the analytical procedures performed during the overall review of the financial statements.
- Misstatements found during the audit, including uncorrected misstatements.
- The qualitative aspects of the company's accounting practices.
- Conditions identified during the audit that relate to fraud risk.
- The presentation of the financial statements, including disclosures.
- The sufficiency and appropriateness of the audit evidence obtained.

### A. Accumulation of Identified Misstatements

1. The auditor should accumulate misstatements identified during the audit, other than those that are clearly trivial.

Not sure
Not trivial

a. "Clearly trivial" is not the same as "not material." Matters that are clearly trivial are inconsequential, both individually and in aggregate, and when judged by any criteria of size, nature, or circumstance. If there is uncertainty about whether an item is clearly trivial, then it cannot be considered trivial.

The auditor may designate an amount below which misstatements are clearly trivial and do not need to be accumulated. The amount should be set so that any misstatement below the amount would not be material to the financial statements, individually or in aggregate, considering the possibility of undetected misstatement.

**PASS KEY**

Based on the results of substantive audit procedures, the auditor will propose adjusting journal entries to the client. The client may or may not book these proposed entries. Management is responsible for the financial statements and has the final decision on whether or not to book the recommended entries. The examiners may ask for basic adjusting journal entries on the audit exam. Adjusting journal entries are discussed in Appendix III.

## B. Evaluation of Misstatements

The auditor must evaluate the materiality of all misstatements found during the audit.

1. The size of a misstatement is often evaluated in comparison to a relevant financial base, such as net income, gross sales, gross margin, total assets, or total liabilities.
2. The auditor must consider the effects, both individually and in the aggregate, of uncorrected misstatements. The misstatements should be evaluated in relation to the specific accounts or disclosures involved and the financial statements as a whole, considering all quantitative and qualitative factors.
3. As the aggregate misstatements accumulated during the audit approaches the materiality level, the auditor should consider the risk that the addition of undetected misstatements could cause materiality levels to be exceeded.
4. Prior period misstatements may affect the financial statements of the current period.
5. Qualitative considerations sometimes may cause an otherwise immaterial misstatement to be deemed material.
   a. The specific circumstances surrounding an entity may lead to situations in which misstatements that do not exceed materiality limits are still likely to influence the economic decisions of users.
   b. Misstatements are more likely to be considered material if they:
      (1) Affect trends in profitability or mask a change in a trend, or change a loss into income (or vice versa).
      (2) Affect the entity's compliance with loan covenants, contracts, or regulatory requirements.
      (3) Increase management compensation, indicate a pattern of management bias, or involve fraud or an illegal act.
      (4) Affect significant financial statement elements, such as those involving recurring earnings (as opposed to those involving nonrecurring items).
      (5) Can be objectively determined, as opposed to including an element of subjectivity.
      (6) Affect segment information presented in the financial statements.
      (7) Misclassify between certain account balances, for example, between operating and nonoperating income or recurring and nonrecurring items.
      (8) Are significant relative to the needs of users.
      (9) Offset effects of individually significant but different misstatements.
      (10) Are currently immaterial, but will have a material effect in the future.
      (11) Are costly to correct.
      (12) Represent a risk that possible additional undetected misstatements could affect the auditor's evaluation.

6. Whether or not a misstatement is considered material is ultimately a matter of professional judgment.

**PCAOB STANDARDS—GUIDANCE FOR ISSUERS**

PCAOB standards state that when evaluating audit findings, the auditor should consider any potential bias in management's judgments about the amounts and disclosures in the financial statements. Examples of management bias include:

- Selective correction of misstatements brought to management's attention during the audit;
- The identification by management of additional adjusting entries that offset misstatements accumulated by the auditor;
- Bias in the selection and application of accounting principles; and
- Bias in accounting estimates.
- If the auditor identifies bias in management's judgments, the auditor should evaluate whether this bias, together with the effect of uncorrected misstatements, results in material misstatement in the financial statements.

## C. Communication and Correction of Misstatements

1. The auditor should communicate on a timely basis with the appropriate level of management all misstatements accumulated during the audit. The auditor should request management to correct those misstatements.
2. If, at the auditor's request, management has examined a class of transactions, account balance, or disclosure and corrected misstatements that were detected, the auditor should perform additional audit procedures to determine whether misstatements remain.
   a. The auditor may request management to examine and perform procedures to determine the amount of the actual misstatement in the class of transactions, account balance, or disclosure, and to make appropriate adjustments to the financial statements. This may occur when the misstatement is based on the auditor's projection of misstatements.
   b. The auditor may request management to record an adjustment needed to correct all factual misstatements including the effect of prior period misstatements other than those that the auditor believes are clearly trivial.
   c. When the auditor has identified a judgmental misstatement involving differences in estimates, such as a difference in a fair value estimate, the auditor may request management to review the assumptions and methods used in developing management's estimate.
3. If management refuses to correct some or all of the misstatements communicated by the auditor, the auditor should obtain an understanding of management's reasons for not making the corrections, and should take that understanding into account when evaluating whether the financial statements as a whole are free from material misstatement.

### D. Documentation Requirements

The auditor should document the following items:

1. The amount below which misstatements are clearly trivial.
2. All misstatements accumulated during the audit and whether they have been corrected.
3. The auditor's conclusion about whether uncorrected misstatements are material, individually or in the aggregate, and the basis for that conclusion.
   a. Documentation of uncorrected misstatements should include:
      (1) The aggregate effect on the financial statements.
      (2) The evaluation of whether the materiality level or levels for particular classes of transactions, account balances, or disclosures, if any, have been exceeded.
      (3) The effect of uncorrected misstatements on key ratios or trends and compliance with legal, regulatory, and contractual requirements (e.g., debt covenants).

## III. REVIEWING THE WORK OF OTHERS

All work performed on the audit should be reviewed to determine whether the work was adequately performed and documented and to evaluate the results of the work relative to the conclusion to be presented in the audit report. The partner with final responsibility for the audit may delegate some of the review responsibility to other members of the audit team, consistent with the firm's system of quality control. Work should be reviewed by members of the audit team who are senior to those who performed the work.

### A. Review Considerations

A review consists of consideration of whether:

1. The work has been performed in accordance with professional standards and applicable laws and regulations.
2. Significant findings or issues need further consideration.
3. Appropriate consultations have taken place and have been documented and implemented.
4. The nature, extent, and timing of the work performed is appropriate and does not need revision.
5. The work performed supports the conclusions reached and is appropriately documented.
6. The evidence obtained is sufficient and appropriate to support the auditor's report.
7. The objectives of the engagement have been achieved.

### B. Engagement Partner Review

The engagement partner should review the following significant findings or issues on a timely basis during the audit to allow resolution on or before the date of the auditor's report:

1. Critical areas of judgment, especially involving difficult to contentious matters
2. Significant risks
3. Other areas the engagement partner considers important

### C. Documentation Requirements

Audit documentation should include:

1. Who performed the work and the date the work was completed.
2. Who reviewed the audit documentation and the date of the review.

## IV. ENGAGEMENT QUALITY REVIEW

PCAOB standards require an engagement quality review and concurring approval of audit report issuance for all audits of issuers and for each engagement to review the interim financial statements of an issuer. Many firms also require engagement quality reviews for nonissuer audits.

### A. Engagement Quality Reviewer

An engagement quality review is performed by a partner who is not otherwise associated with the engagement. The engagement quality reviewer must be competent, independent, objective and act with integrity.

### B. Engagement Quality Review Process

Under PCAOB standards, the engagement quality reviewer is required to hold discussions with the engagement partner and other members of the engagement team and review the audit documentation in order to evaluate the significant judgments made by the engagement team and the overall conclusion reached on the engagement. The engagement quality reviewer should do the following:

1. Evaluate the significant judgments related to engagement planning, including the firm's prior experience with the client, risks identified related to the client, and judgments about materiality.
2. Evaluate the engagement team's assessment of and responses to significant risks, including fraud risk.
3. Evaluate significant judgments about materiality, corrected and uncorrected misstatements, and control deficiencies.
4. Review the evaluation of the firm's independence in relation to the engagement.
5. Review the engagement completion document and confirm that there are no unresolved matters.
6. Review the financial statements, management's report on internal control, and the engagement report.
7. Read other information to be filed with the SEC and determine whether appropriate action has been taken with respect to material inconsistencies or material misstatements of fact.
8. Evaluate the consultations, documentation, and conclusions related to difficult or contentious matters.
9. Evaluate communications with management, the audit committee, and regulatory bodies.
10. Evaluate whether engagement documentation indicates that the engagement team responded appropriately to significant risks and whether such documentation supports the conclusions reached by the engagement team.

## C. Concurring Approval of Issuance

Under PCAOB standards, the firm cannot give the client permission to use the engagement report until the engagement quality reviewer provides concurring approval of issuance. The engagement quality reviewer may provide concurring approval of issuance only if there are no significant engagement deficiencies.

A significant engagement deficiency exists when:

1. The engagement team failed to obtain sufficient appropriate evidence.
2. The engagement team reached an inappropriate overall conclusion.
3. The engagement report is not appropriate for the circumstances.
4. The firm is not independent of the client.

# APPENDIX I

## Financial Ratios

Ratio Analysis

## I. OVERVIEW

Ratios are financial indicators that distill relevant information about a business entity by quantifying the relationships among selected items on the financial statements. An entity's ratios may be compared to ratios of a different period and to industry ratios. These comparative analyses identify trends that may be important to investors, lenders, and other interested parties.

**PASS KEY**

Ratio questions on the auditing exam may require a simple ratio calculation, an interpretation of what the ratio means, or an analysis of the effects of a change. Sometimes, when both the numerator and denominator are affected by a given change, the final result (increase or decrease) is not easy to determine. The best way to answer questions like these is to make up numbers and plug them into the ratio formula.

## II. BASIC FINANCIAL ANALYSIS RATIOS

Key financial ratios may be classified as:

### A. Liquidity Ratios

Liquidity ratios are measures of a firm's short-term ability to pay maturing obligations.

### B. Activity Ratios

Activity ratios are measures of how effectively an enterprise is using its assets.

### C. Profitability Ratios

Profitability ratios measure the financial performance of an enterprise for a given time period.

### D. Investor Ratios

Investor ratios are measures that are of interest to investors.

### E. Long-term Debt-Paying Ability Ratios *(coverage ratios)*

Coverage ratios are measures of security for long-term creditors/investors.

## III. LIMITATIONS OF RATIOS

Although ratios are easy to compute, they depend entirely on the reliability of the data on which they are based (e.g., on estimates and on historical costs).

Other limitations include:

(i) There are few industry benchmarks for comparison.

(ii) Dissimilar business units may make analysis difficult.

(iii) Inflation can reduce comparability of balance sheet items.

(iv) Manipulation of ratios by management can occur.

(v) The choice of different generally accepted accounting principles can affect ratios and reduce comparability.

(vi) Generalizations are difficult to make.

(vii) Ratios may use accounting data (e.g., fixed assets) that do not reflect fair values.

## IV. OTHER ANALYSES

Additional analyses, such as common size analysis (vertical and horizontal), analysis of industry statistics, and trend analysis, may also be valuable.

### A. Common Size Analysis

Common size financial statements are used to compare a company's performance with the performance of other smaller or larger companies, or with its own performance over time. To draft a common size balance sheet, simply divide each balance by the total assets. The result is that each balance sheet component is expressed as a percentage of the whole, with total assets representing 100%. Similarly, to draft a common size income statement, simply divide each income statement amount by the total revenue. Common size financial statements can be compared to industry norms or to competitors.

### B. Analysis of Industry Statistics

Ratio analysis is useful when comparing to norms in an industry. Benchmarking may be performed against competitors or industry averages.

### C. Trend Analysis

Ratio analysis can be used to analyze trends over time.

## V. COMPREHENSIVE EXAMPLE

The following pages provide a comprehensive example illustrating how a variety of ratios can be computed based on given financial information.

**EXAMPLE**

*Gi Company*
Balance Sheet

| | December 31 Year 2 | December 31 Year 1 |
|---|---|---|
| **Current Assets:** | | |
| Cash and cash equivalents | $ 50,000 | $ 35,000 |
| Trading securities (at fair value) | 75,000 | 65,000 |
| Accounts receivable | 300,000 | 290,000 |
| Inventory (at lower of cost or market) | 290,000 | 275,000 |
| Total current assets | 715,000 | 665,000 |
| Investments available-for-sale (at fair value) | 350,000 | 300,000 |
| Fixed Assets: | | |
| Property, plant, and equipment (at cost) | 1,900,000 | 1,800,000 |
| Less: Accumulated depreciation | (385,000) | (350,000) |
| | 1,515,000 | 1,450,000 |
| Goodwill | 35,000 | 35,000 |
| Total assets | $2,615,000 | $2,450,000 |
| **Current Liabilities:** | | |
| Accounts payable | $ 150,000 | $ 125,000 |
| Notes payable | 325,000 | 375,000 |
| Accrued and other liabilities | 220,000 | 200,000 |
| Total current liabilities | 695,000 | 700,000 |
| **Long-term Debt:** | | |
| Bonds and notes payable | 650,000 | 600,000 |
| Total liabilities | 1,345,000 | 1,300,000 |
| **Stockholders' Equity:** | | |
| Common stock (100,000 shares outstanding) | 500,000 | 500,000 |
| Additional paid-in capital | 350,000 | 350,000 |
| Retained earnings | 420,000 | 300,000 |
| Total equity | 1,270,000 | 1,150,000 |
| Total liabilities and equity | $2,615,000 | $2,450,000 |

In addition, assume the following information for Gi Company for the year ended December 31, Year 2:

| | |
|---|---|
| Sales | $1,800,000 |
| Cost of goods sold | (1,000,000) |
| Gross profit | 800,000 |
| Operating expenses | (486,970) |
| Interest expense | (10,000) |
| Net income before income taxes | 303,030 |
| Income taxes (34%) | (103,030) |
| Net income after income taxes | $ 200,000 |
| Earnings per share | $2 |
| Operating cash flows | $255,000 |
| Dividends for the year | $0.80 per share |
| Market price per share | $12 |

## LIQUIDITY RATIOS

1. **Working capital** = Current assets – Current liabilities

   Year 2: $715,000 – $695,000 = $20,000

   Year 1: $665,000 – $700,000 = ($35,000)

2. **Current ratio (working capital ratio)** $= \dfrac{\text{Current assets}}{\text{Current liabilities}}$

   $$(\text{Year 2}) = \frac{\$715{,}000}{\$695{,}000} = 1.03$$

   $$(\text{Year 1}) = \frac{\$665{,}000}{\$700{,}000} = 0.95$$

   (Industry average = 1.5)

   The ratio, and therefore Gi's ability to meet its short-term obligations, has improved, though it is low compared to the industry's average.

3. **Acid-test ratio** $= \dfrac{\text{Cash equivalents + Marketable securities + Accounts receivable}}{\text{Current liabilities}}$

   $$(\text{Year 2}) = \frac{\$50{,}000 + \$75{,}000 + \$300{,}000}{\$695{,}000} = 0.61$$

   $$(\text{Year 1}) = \frac{\$35{,}000 + \$65{,}000 + \$290{,}000}{\$700{,}000} = 0.56$$

   (Industry average = 0.80)

   The industry average of .80 is higher than Gi's ratio, which indicates that Gi may have trouble meeting short-term needs.

4. **Cash ratio** $= \dfrac{\text{Cash equivalents + Marketable securities}}{\text{Current liabilities}}$

   $$(\text{Year 2}) = \frac{\$50{,}000 + \$75{,}000}{\$695{,}000} = 0.18$$

   $$(\text{Year 1}) = \frac{\$35{,}000 + \$65{,}000}{\$700{,}000} = 0.14$$

## ACTIVITY RATIOS

**PASS KEY**

Turnover ratios generally use average balances (i.e., [beginning balance + ending balance] / 2) for balance sheet components. However, on some recent CPA Exam questions, candidates have been instructed to use year-end balances instead. Please be sure to read the question carefully to determine the appropriate method to use.

1. **Accounts receivable turnover**

$$= \frac{\text{Net credit sales}}{\text{Average net receivables}}$$

$$= \frac{\$1{,}800{,}000}{(\$300{,}000 + \$290{,}000) / 2}$$

$$= \frac{\$1{,}800{,}000}{\$295{,}000}$$

$$= 6.10 \text{ times}$$

This ratio indicates the receivables' quality and indicates the success of the firm in collecting outstanding receivables. Faster turnover gives credibility to the current and acid-test ratios.

2. **Accounts receivable turnover in days**

$$= \frac{\text{Average net receivables}}{\text{Net credit sales} / 365}$$

$$= \frac{365 \text{ days}}{\text{Receivable turnover}}$$

$$= \frac{365 \text{ days}}{6.1}$$

$$= 59.84 \text{ days}$$

This ratio indicates the average number of days required to collect accounts receivable.

3. **Inventory turnover**

$$= \frac{\text{Cost of goods sold}}{\text{Average inventory}}$$

$$= \frac{\$1{,}000{,}000}{(\$290{,}000 + \$275{,}000) / 2}$$

$$= \frac{\$1{,}000{,}000}{\$282{,}500}$$

$$= 3.54 \text{ times}$$

This measure of how quickly inventory is sold is an indicator of enterprise performance. The higher the turnover, in general, the better the performance.

4. **Inventory turnover in days** $= \dfrac{\text{Average inventory}}{\text{Cost of goods sold / 365}}$

$= \dfrac{\text{365 days}}{\text{Inventory turnover}}$

$= \dfrac{\text{365 days}}{3.54}$

$=$ 103.11 days

This ratio indicates the average number of days required to sell inventory.

5. **Operating cycle** = AR turnover in days + Inventory turnover in days

= 59.84 days + 103.11 days

= 162.95 days

The operating cycle indicates the number of days between acquisition of inventory and realization of cash from selling the inventory.

6. **Working capital turnover** $= \dfrac{\text{Sales}}{\text{Average working capital}}$

$= \dfrac{\$1{,}800{,}000}{[(\$715{,}000 - \$695{,}000) + (\$665{,}000 - \$700{,}000)] / 2}$

$=$ 240 times

This ratio indicates how effectively working capital is used.

7. **Total asset turnover** $= \dfrac{\text{Net sales}}{\text{Average total assets}}$

$= \dfrac{\$1{,}800{,}000}{(\$2{,}615{,}000 + \$2{,}450{,}000) / 2}$

$= \dfrac{\$1{,}800{,}000}{\$2{,}532{,}500}$

$=$ 0.71 times

This ratio is an indicator of how Gi makes effective use of its assets. A high ratio indicates effective asset use to generate sales.

8. **Accounts payable turnover**

$$= \frac{\text{Purchases}}{\text{Average accounts payable}}$$

$$= \frac{\$1{,}015{,}000}{(\$150{,}000 + \$125{,}000) / 2}$$

$$= 7.38 \text{ times}$$

This ratio indicates the number of times trade payables turn over during the year. A low turnover may indicate a delay in payment, such as from a shortage of cash. Purchases may be calculated based on the equation:

| | | |
|---|---|---|
| Beginning inventory + Purchases – Cost of goods sold | = | Ending inventory |
| \$275,000 + Purchases – \$1,000,000 | = | \$290,000 |
| Purchases | = | \$1,015,000 |

9. **Days in accounts payable**

$$= \frac{\text{Average accounts payable}}{\text{Purchases / 365}}$$

$$= \frac{\text{365 days}}{\text{Accounts payable turnover}}$$

$$= \frac{\text{365 days}}{7.38}$$

$$= 49.45 \text{ days}$$

This ratio indicates the average length of time trade payables are outstanding before they are paid.

## PROFITABILITY RATIOS

1. **Net profit margin**

$$= \frac{\text{Net income}}{\text{Net sales}}$$

$$= \frac{\$200{,}000}{\$1{,}800{,}000}$$

$$= 11.11\%$$

This ratio indicates profit rate and, when used with the asset turnover ratio, indicates rate of return on assets, as shown in item 3 below.

2. **Return on total assets**

= Net income ÷ Average total assets

= $200,000 / $2,532,500

= 7.9%

3. **Return on assets** (alternate version)

= Net profit margin × Total asset turnover

$$= \frac{\text{Net income}}{\text{Net sales}} \times \frac{\text{Net sales}}{\text{Average total assets}}$$

= 11.11% × 0.71 times = 7.9%

Note that this ratio uses both net profit margin and the total asset turnover. This ratio allows for increased analysis of the changes in percentages. The net profit margin indicates the percent return on each sale while the asset turnover indicates the effective use of assets in generating that sale.

4. **Return on investment**

$$= \frac{\text{Net income + Interest expense (1 – Tax rate)}}{\text{Average (Long-term liabilities + Equity)}}$$

$$= \frac{\$200{,}000 + \$10{,}000\ (1 - 0.34)}{(\$650{,}000 + \$1{,}270{,}000 + \$600{,}000 + \$1{,}150{,}000)\ /\ 2}$$

= 11.3%

ROI measures the performance of the firm without regard to the method of financing.

5. **Return on common equity**

$$= \frac{\text{Net income – Preferred dividends}}{\text{Average common equity}}$$

$$= \frac{\$200{,}000 - \$0}{(\$1{,}270{,}000 + \$1{,}150{,}000)\ /\ 2}$$

= 16.5%

This ratio uses net income less preferred dividends in the numerator to better measure returns accruing to common shareholders.

6. **Net operating margin percentage**

$$= \frac{\text{Net operating income}}{\text{Net sales}}$$

$$= \frac{\$800{,}000 - 486{,}970}{\$1{,}800{,}000}$$

$$= 17.39\%$$

7. **Gross (profit) margin percentage**

$$= \frac{\text{Gross (profit) margin}}{\text{Net sales}}$$

$$= \frac{\$800{,}000}{\$1{,}800{,}000}$$

$$= 44\%$$

8. **Operating cash flow per share**

$$= \frac{\text{Operating cash flow}}{\text{Common shares outstanding}}$$

$$= \frac{255{,}000}{100{,}000 \text{ shares}}$$

$$= \$2.55 \text{ per share}$$

## INVESTOR RATIOS

1. **Degree of financial leverage**

$$= \frac{\text{Earnings before interest and taxes}}{\text{Earnings before taxes}}$$

$$= \frac{\$303{,}030 + \$10{,}000}{\$303{,}03}$$

$$= 1.033$$

The degree of financial leverage is the factor by which net income will change with a change in earnings before interest and taxes. The degree of financial leverage indicates the leverage factor for recurring earnings.

2. **Earnings per share**

$$= \frac{\text{Net income} - \text{Preferred dividends}}{\text{Weighted average number of common shares outstanding}}$$

$$= \frac{\$200{,}000 - \$0}{100{,}000 \text{ shares}}$$

$$= \$2/\text{share}$$

3. **Price/earnings ratio**

$$= \frac{\text{Market price per share}}{\text{Diluted earnings per share}}$$

$$= \frac{\$12}{\$2}$$

$$= 6$$

This statistic indicates the investment potential of an enterprise; a rise in this ratio indicates that investors are pleased with the firm's opportunity for growth.

4. **Dividend payout ratio**

$$= \frac{\text{Dividends per common share}}{\text{Diluted earnings per share}}$$

$$= \frac{\$0.80}{\$2}$$

$$= 40\%$$

This ratio indicates the portion of current earnings being paid out in dividends.

5. **Dividend yield** $= \dfrac{\text{Dividends per common share}}{\text{Market price per common share}}$

$$= \frac{\$0.80}{\$12}$$

$$= 6.67\%$$

This ratio indicates the relationship between dividends and market price.

6. **Book value per share** $= \dfrac{\text{Total stockholders' equity – Preferred stock}}{\text{Number of common shares outstanding}}$

(Year 2) $= \dfrac{\$1{,}270{,}000}{100{,}000 \text{ shares}} = \$12.70$

(Year 1) $= \dfrac{\$1{,}150{,}000}{100{,}000 \text{ shares}} = \$11.50$

This ratio indicates the amount of stockholders' equity that relates to each share of common stock. Note that preferred stock should be stated at liquidity value if other than book value.

## LONG-TERM DEBT-PAYING ABILITY RATIOS

1. **Debt / Equity** $= \dfrac{\text{Total liabilities}}{\text{Common stockholders' equity}}$

   (Year 2) = \$1,345,000 / \$1,270,000 = 1.06

   (Year 1) = \$1,300,000 / \$1,150,000 = 1.13

   This ratio indicates the degree of protection to creditors in case of insolvency. The lower this ratio the better the company's position. In Gi's case, the ratio is very high, indicating that a majority of funds come from creditors. However, the ratio is improving.

2. **Debt ratio** $= \dfrac{\text{Total liabilities}}{\text{Total assets}}$

   (Year 2) = \$1,345,000 / \$2,615,000 = 51.4%

   (Year 1) = \$1,300,000 / \$2,450,000 = 53.1%

   This debt ratio indicates that more than half of the assets are financed by creditors.

3. **Times interest earned** $= \dfrac{\text{Earnings before taxes and interest}}{\text{Interest}}$

   $= \dfrac{\$303{,}030 + \$10{,}000}{\$10{,}000}$

   = 31.30 times

   This ratio reflects the ability of a company to cover interest charges. It uses income before interest and taxes to reflect the amount of income available to cover interest expense.

4. **Operating cash flow / Total debt** $= \dfrac{\text{Operating cash flow}}{\text{Total debt}}$

   $= \dfrac{\$255{,}000}{\$1{,}345{,}000}$

   = 18.96%

   This ratio indicates the ability of the company to cover total debt with yearly cash flow.

# APPENDIX II
## Control Procedures and Tests of Controls

## I. TESTING CONTROLS: SALES

| TESTING CONTROLS: SALES | | |
|---|---|---|
| *Department* | *Control Procedure* | *Sample Test of Control Procedure* |
| *Order & Credit* | 1. Prepare prenumbered sales order.<br>2. Perform credit check (authorization).<br>3. Approve credit for returns.<br>4. Follow up on old or past-due accounts.<br>5. Initiate write-offs, which should be approved by the treasurer. | • Inquire about credit procedure for new customers (valuation).<br>• From a population of approved sales orders (and returns), select a sample and examine documents for evidence of credit check (valuation). |
| *Warehouse & Shipping* | 1. Receive approved sales order from credit dept. (must have approved sales order before release of goods from warehouse).<br>2. Pull inventory from warehouse and release to shipping.<br>3. Perform independent check of goods received from warehouse and approved sales orders in shipping department.<br>4. Prepare II bill of lading. | • Observe warehouse personnel filling sales orders (existence).<br>• Observe physical controls over inventory.<br>• Observe evidence of independent checks (existence).<br>• Inspect a sample of prenumbered shipping documents and:<br>- Agree to sales order (existence).<br>- Account for prenumbering (completeness). |
| *Billing/Accounts Receivable* | 1. Match shipping documents and sales orders before preparing invoice.<br>2. Periodically account for all prenumbered shipping documents.<br>3. Perform independent check of sales order pricing.<br>4. Prepare prenumbered sales invoice.<br>5. Batch and total invoices.<br>6. Update A/R master file. Agree input to invoice batch totals.<br>7. Print sales journal.<br>8. Print sales summary. Agree to invoice batch totals (independent check).<br>9. Mail monthly customer statements. | • Vouch a sample of sales invoices (select approved sales orders from the sales journal) to shipping documents and approved sales orders (existence).<br>• Trace a sample of shipping documents (selection from prenumbered shipping documents) to sales invoice, sales journal, and A/R master file (completeness).<br>• Observe procedures. Reperform procedures for a sample period (completeness).<br>• Reperform pricing check: From a sample of sales invoices, check pricing with master price list (valuation).<br>• Observe procedures and reperform (valuation).<br>• Observe mailing (existence, completeness, valuation). |

| TESTING CONTROLS: SALES | | |
|---|---|---|
| *Department* | *Control Procedure* | *Sample Test of Control Procedure* |
| *Accounting* | 1. Receive sales summary.<br>2. Perform independent check of invoice batch totals and sales summary.<br>3. Review sales account classifications.<br>4. Post to G/L.<br>5. Follow-up customer exceptions (independent check). | • Observe and reperform (valuation, existence, completeness).<br>• Observe and reperform (report presentation).<br>• Inspect customer exception file and disposition (existence, completeness, rights, valuation). |
| NOTE: A formal audit program can be prepared and organized by assertion and sample population. | | |
| **SEGREGATION OF DUTIES:**<br>Authorization: Sales Order & Credit, Treasurer<br>Record keeping: Billing/Accounts Receivable/Accounting<br>Custody: Warehouse & Shipping | | |

## II. TESTING CONTROLS: CASH RECEIPTS

| TESTING CONTROLS: CASH RECEIPTS | | |
|---|---|---|
| *Department* | *Control Procedure* | *Sample Test of Control Procedure* |
| *Mail Room* | 1. Separate checks and remittance advices.<br>2. Stamp restrictive endorsement on checks.<br>3. Prepare prelisting of checks received.<br>4. Forward checks to Cashier.<br>Forward remittance advices to A/R.<br>Forward prelisting to Accounting, Cashier, and Accounts Receivable. | • Inspect checks prior to deposit for endorsement (completeness).<br>• Observe preparation of prelisting (existence, completeness, valuation). |
| *Cashier* | 1. Receive checks and prepare deposit.<br>2. Prepare daily cash summary (copy to A/R and Accounting).<br>3. Deliver checks to bank.<br>4. File validated deposit slip. | • Observe preparation of cash summary (existence, completeness, valuation).<br>• Inspect deposit slip and compare to cash summary (existence, completeness, valuation). |
| *Accounts Receivable* | 1. Match remittance advices and check deposit summary.<br>2. Update A/R master file.<br>3. Print CR journal/Updated A/R master file.<br>4. Print CR summary (copy to Accounting). | • Observe procedure (completeness). |
| *Accounting* | 1. Independent check: Compare the cash summary (Cashier), the prelisting of checks (Mail Room), and the CR summary (A/R).<br>2. Post G/L.<br>3. Prepare bank reconciliation. | • Inspect evidence of independent check (existence, completeness, valuation).<br>• Reperform independent check for selected dates (existence, completeness, valuation).<br>• Inspect bank reconciliation (existence, completeness, valuation). |
| **SEGREGATION OF DUTIES:**<br>Record keeping: Accounts Receivable/Accounting<br>Custody: Mail Room & Cashier (Treasurer) | | |

## III. TESTING CONTROLS: PURCHASES

| TESTING CONTROLS: PURCHASES | | |
|---|---|---|
| *Department* | *Control Procedure* | *Sample Test of Control Procedure* |
| *Requisitioner* | 1. Prepare prenumbered requisition.<br>2. Obtain approvals needed (authorization).<br>3. Send original copy to Purchasing.<br>4. Inspect goods when received from Receiving Dept. Sign receiving report upon receipt of goods (independent check). | • Inspect requisitions for proper approval.<br>• Observe procedures to account for prenumbering. |
| *Purchasing* | 1. Receive approved requisition.<br>2. Contact approved vendors.<br>3. Issued prenumbered purchase order (PO):<br>✓ Original to vendor<br>✓ Blind copy to Receiving<br>✓ Copy to A/P<br>✓ File copy | • Inspect purchase orders for approved requisition.<br>• Observe procedures to account for prenumbering. |
| *Receiving* | 1. Receive goods from vendor.<br>2. Inspect goods. All shipments received must have a PO.<br>3. Prepare receiving report (RR).<br>4. Match details of order received with blind copy of PO and indicate quantity received.<br>5. Send goods to Requisitioning department. Obtain signature on receiving report that requisitioner received goods.<br>6. Distribute receiving report:<br>✓ Original to A/P<br>✓ Copy to Purchasing<br>✓ File copy | • Inspect receiving report and matching PO.<br>• Observe performance by receiving clerk.<br>• Inspect receiving report for signed receipt (existence).<br>• Trace a sample of receiving reports (selection made from prenumbered documents) to PO, requisition, invoice, and entry in the purchase journal and A/P master file (completeness). |
| *Accounts Payable* | 1. Receive vendor's invoice.<br>2. Match documents: vendor's invoice, RR, PO, requisition.<br>3. Check mathematical accuracy, approvals, G/L account coding (independent check).<br>4. Prepare prenumbered voucher.<br>5. Account for the numerical sequence of vouchers.<br>6. Data Entry:<br>✓ Prepare purchase journal<br>✓ Update A/P master file<br>✓ Daily purchase summary<br>7. Reconcile daily purchase summary totals and daily entries to purchases journal. | • Inspect vouchers for supporting documents and evidence of independent checks (existence).<br>• Observe procedure; reperform (completeness).<br>• Vouch a sample of vouchers (selection made from the purchases journal) to all required supporting documents (existence).<br>• Observe evidence of independent check; reperform (valuation). |
| *Accounting* | 1. Receive purchase summary.<br>2. Post to G/L.<br>3. Reconcile G/L and A/P file.<br>4. Reconcile vendor's monthly statements and A/P master file (independent check). | • Observe evidence of independent check; reperform.<br>• Observe evidence of independent check; reperform (valuation, existence, completeness). |

**SEGREGATION OF DUTIES:**

Authorization: Purchasing/Requisitioning Dept.

Record keeping: Accounts Payable/Accounting

Custody: Receiving

## IV. TESTING CONTROLS: PAYABLES AND CASH DISBURSEMENTS

**TESTING CONTROLS: PAYABLES AND CASH DISBURSEMENT**

| *Department* | *Control Procedure* | *Sample Test of Control Procedure* |
|---|---|---|
| *Accounts Payable* | 1. Pull voucher at due date and send to Treasurer for payment. | • Compare debits to accounts payable to properly cancelled voucher packages (existence). |
| | 2. Receive cancelled voucher and supporting documents from Treasurer. | • Trace from cancelled voucher packages to cash disbursement journal entries (completeness). |
| | 3. Receive check summary from Treasurer for data entry. | • Vouch cash disbursement journal entries back to cancelled voucher packages (existence). |
| | 4. Data Entry:<br>✓ Update A/P master file.<br>✓ Print cash disbursements journal. | |
| *Treasurer* | 1. Receive voucher for payment. | • Observe performance of independent check. |
| | 2. Review document for completeness and approvals. | • Observe accounting for sequence (completeness). |
| | 3. Prepare prenumbered checks. | |
| | 4. Prepare check summary. | |
| | 5. Sign checks (authorized signatory) and cancel voucher and supporting documents. | |
| | 6. Mail check to vendor. | |
| | 7. Forward cancelled voucher/supporting documents to Accounts Payable. | • Inquire about procedure; observe. Select checks for testing and inspect signatures. |
| | 8. Send copy of check summary:<br>✓ Accounts Payable<br>✓ Accounting | • Observe cancellation of vouchers by check signer.<br>• Inquire about procedure. Observe performance. |
| *Accounting* | 1. Receive check summary. | |
| | 2. Post to G/L. | • Observe procedure and reperform. |
| | 3. Perform independent check of totals per check summary and amounts journalized and posted by A/P. | |
| | 4. Perform periodic independent bank reconciliation. | • Inspect bank reconciliation. |

**SEGREGATION OF DUTIES:**

Authorization: Purchasing/Requisitioning Department

Record keeping: Accounts Payable/Accounting

Custody: Receiving (purchased item) and Treasurer (cash)

# APPENDIX III
## Adjusting Journal Entries

## I. OVERVIEW

Journal entries may be on any accounts that appear in the financial statements. These questions often require basic knowledge of journal entries. (For example, revenue related to Year 2 should not be included in Year 1 revenue.) Some methods the examiners may use to test adjusting entries can be found below (but this is not meant to be a comprehensive list).

### A. Correct Accounts That Are Overstated or Understated

1. For questions related to adjusting accounts that are overstated or understated, it is important to be familiar with the natural debit or credit balance of an account. With the exception of contra-accounts, the general rule is:
   a. Assets have a natural debit balance.
   b. Liabilities and stockholder equity have a natural credit balance.
   c. Sales have a natural credit balance.
   d. Expenses have a natural debit balance.
2. Knowing the natural balance of accounts will help you understand how to adjust journal entries. For example, if sales made "on account" are overstated, this means that the auditor thinks sales and the related receivable are too large and need to be smaller. To decrease these accounts, the auditor would propose:

| | | | |
|---|---|---|---|
| DR | Sales | $XXX | |
| CR | Accounts receivable | | $XXX |

(*To adjust sales and accounts receivable to correct amounts.*)

Rationale: Sales has a natural credit balance, so sales should be debited to decrease it. Accounts receivable has a natural debit balance, so accounts receivable should be credited to decrease it.

### B. Contingencies

Questions may ask about contingencies and whether the financial statements should be adjusted. Contingencies are discussed in more detail in the F10 lecture, but a high level summary is:

| | *Can Estimate Loss Amount* | *Cannot Estimate Loss Amount* |
|---|---|---|
| *Probable* | Accrue and disclose | Disclose |
| *Reasonably possible* | Disclose | Disclose |
| *Remote* | May ignore or may disclose | |

### C. Purchases and Inventory

#### 1. Purchases

Questions related to purchases may require knowledge of free on board (FOB) shipping point and FOB destination. It is important to note whether the client is the buyer or seller to help determine whether purchases (such as inventory) should be included or excluded from a balance.

##### a. If the Client Is the Buyer

(1) *FOB shipping point*: An item shipped FOB shipping point should be included in the client's inventory as soon as the item is with the carrier (e.g., in a FedEx truck).

(2) *FOB destination*: An item shipped FOB destination should be included in the client's inventory as soon as the item has reached the destination (e.g., the client's place of business).

**b. If the Client Is the Seller**

(1) *FOB shipping point*: An item shipped FOB shipping point should be excluded from the client's inventory as soon as the item is with the carrier (e.g., in a FedEx truck).

(2) *FOB destination*: An item shipped FOB destination should be excluded from the client's inventory as soon as the item has reached the destination (e.g., the buyer's place of business).

**2. Inventory**

**a. Perpetual Inventory**

In a perpetual inventory system the journal entries to record the sale of inventory are:

| | | | |
|---|---|---|---|
| DR | Cash or accounts receivable | $XXX | |
| CR | Sales | | $XXX |

*(To record the sale of an item.)*

AND

| | | | |
|---|---|---|---|
| DR | Cost of goods sold | $XXX | |
| CR | Inventory | | $XXX |

*(To record the relief of inventory.)*

**b. Periodic Inventory System**

In a periodic inventory system, sales are recorded after every sale is made, while inventory is adjusted at the end of the period through a periodic count. The formula to calculate cost of goods sold is:

Beginning inventory
\+ Purchases
= Cost of goods sold available for sale
– Ending inventory (based on physical inventory count)
= Cost of goods sold

The journal entry to record a sale under the periodic method is:

| | | | |
|---|---|---|---|
| DR | Cash or accounts receivable | $XXX | |
| CR | Sales | | $XXX |

(*To record the sale of inventory.*)

Cost of goods sold are recorded at period end. The journal entry at the end of the period (based on the formula above) would be:

| | | | |
|---|---|---|---|
| DR | Cost of goods sold | $XXX | |
| CR | Inventory | | $XXX |

*(To record the relief of inventory.)*

**EXAMPLE**

The auditor is auditing ABC Company, which utilizes a periodic inventory system. The auditor discovered that inventory stored at a distribution center on December 31, Year 2, was inadvertently omitted during the Year 2 physical inventory count. This inventory was valued at $20,000. What should the adjusting journal entry be?

| | | | |
|---|---|---|---|
| DR | Inventory | $20,000 | |
| CR | Cost of Goods Sold | | $20,000 |

(*To correct inventory and cost of goods sold for inventory held at off-site location.*)

The company needs to increase inventory by $20,000. In addition, when the company computed cost of goods sold, the ending inventory was lower by $20,000, which resulted in a higher cost of goods sold of $20,000. To decrease cost of goods sold, the auditor would propose a credit to cost of goods sold for $20,000.

c. **Consignment**

(1) *Audit client is the consignee (holding another company's goods)*: This inventory should be excluded from the client's financial statements.

(2) *Audit client is the consignor (goods are held at consignee's place of business)*: This inventory should be included in the client's financial statements.

## D. Subsequent Events

1. Type I events require adjustment of the financial statements. Type I events provide additional evidence with respect to conditions that existed at the date of the balance sheet and affect the estimates inherent in the process of preparing financial statements. All information that becomes available prior to the issuance of the financial statements should be used by management in its evaluation of the conditions on which the estimates were based. Examples include:

   a. Loss on an uncollectible trade account receivable as a result of a customer's deteriorating financial condition leading to bankruptcy subsequent to the balance sheet date. This event gives more information about the customer's condition that existed at the balance sheet date. Note that the customer's condition was already deteriorating as of the balance sheet date; therefore, the balance sheet should be adjusted to reflect this.

   b. Settlement of litigation for an amount different from the liability recorded in the accounts would require adjustment of the financial statements if the event that gave rise to the litigation took place prior to the balance sheet date.

2. Type II events require disclosure only in the financial statements. These events provide evidence with respect to conditions that did not exist at the date of the balance sheet but arose subsequent to that date. Examples include:

   a. Sale of a bond or capital stock issue subsequent to the balance sheet date.

   b. Purchase of a business subsequent to the balance sheet date.

   c. Settlement of litigation when the event giving rise to the claim took place subsequent to the balance sheet date.

   d. Loss of plant or inventories as a result of fire or flood subsequent to the balance sheet date.

# AUDITING 5

*Sampling and Communications*

# NOTES

# AUDIT SAMPLING

Objective: obtain sufficient, appropriate audit evidence

## I. INTRODUCTION

Statistical Sampling

### A. Audit Sampling

Acceptance of risk

*Audit sampling* is the testing of less than 100% of the items within an account balance or class of transactions in order to evaluate some characteristic of the balance or class. Audit sampling is especially useful in cases where an auditor has no special knowledge about likely misstatements contained in account balances and transactions.

**PASS KEY**

**RULE 1**

Always assume that the population being sampled is normally distributed, that is, it can be described by a "normal," or "bell-shaped," curve.

Central limit theorem

**RULE 2**

For the estimates that the CPA makes about the population to have mathematical validity, the samples have to be unrestricted and randomly selected, which means that:

1. Every item in a population must have an absolutely equal chance of being selected.
2. The CPA cannot use "bias" in deciding which items will be selected. No substitute items may be used.

Only area where CPA does not use judgment

**RULE 3**

If the sample is large enough and is randomly selected, the sample will likely have the same statistical characteristics (mean and standard deviation) as the underlying population, i.e. it will be representative of the population.

**RULE 4**

Variability → Uncertainty ← Larger sample size

Standard deviation is a measure of "variability," which refers to the range of values within the population.

### B. Representative of the Population

When auditors sample from a population (universe), the assumption is that the sample is representative of the population (i.e., the characteristics of the sample are comparable to the characteristics of the population).

### C. Sampling Risk

Inherent in audit sampling is the concept of *sampling risk*. This is the risk that the sample is not representative of the population and that the auditor's conclusion will be different from the conclusion had the auditor examined 100% of the population.

### D. Sampling

Audit *sampling* methods can be either statistical or nonstatistical. Both approaches require the use of professional judgment.

GAAS

#### 1. Statistical Sampling

In *statistical sampling*, auditors specify the sampling risk they are willing to accept and then calculate the sample size that provides that degree of reliability. Results are evaluated quantitatively.

2. **Nonstatistical Sampling**

In *nonstatistical sampling*, the sample size is not determined mathematically. Auditors use their judgment in determining sample size, and sample results are evaluated judgmentally.

3. **Sufficient Audit Evidence**

Either a statistical or a nonstatistical approach is acceptable under generally accepted auditing standards. When properly applied, either method should result in a sample size that provides *sufficient audit evidence*.

a. The sufficiency of audit evidence is related to the design and size of the sample.

b. The size of a sample depends on both the objectives and the design of the sample. Careful design generally produces a more efficient sample (i.e., one that achieves its objectives with a smaller sample size).

4. **Professional Judgment**

Although statistical sampling aids the auditor in quantitative ways, it is not a substitute for *professional judgment*. The auditor must exercise professional judgment in both statistical and nonstatistical sampling to:

a. define the population and the sampling unit;

b. select the appropriate sampling method;

c. evaluate the appropriateness of audit evidence;

d. evaluate the nature of deviations or errors;

e. consider sampling risk; and

f. evaluate the results obtained from the sample and project those results to the population.

*

**PASS KEY**

Many questions try to trick the candidate into thinking that statistical sampling eliminates the need for auditing judgment. This is completely false. While statistical sampling is a quantitative approach, judgment is still required to set many of the parameters and to evaluate the overall results.

E. **Statistical Sampling**

1. **Advantages of Statistical Sampling**

*Statistical sampling* enables the auditor to:

a. Measure the sufficiency of the audit evidence obtained.

b. Provide an objective basis for quantitatively evaluating sample results.

c. Design an efficient sample.

d. Quantify sampling risk so as to limit risk to an acceptable level.

2. **Random Sample Selection** - To follow "rule 2" for statistical sampling

*Random sample selection* methods should be used in statistical sampling. Such methods give all items in the population an equal chance to be included in the sample to be audited.

### F. Use of Sampling

#### 1. Types of Sampling

Auditors may use sampling procedures to estimate many different characteristics of populations, but generally estimates are either of a rate of occurrence (attribute sampling) or of a numerical quantity (variables sampling or probability-proportional-to-size [PPS] sampling).

Testing characteristics, flagging errors

a. Attribute sampling is primarily used for testing internal controls.

b. Variables sampling and PPS sampling are typically used in substantive testing of account balances.

Estimate of $ value of the population

**PASS KEY**

*

Many exam questions can be answered by being able to distinguish between attribute sampling and variables sampling applications. Remember that attribute sampling is more likely to deal with tests of controls, while variables sampling generally deals with dollar values. Often the attribute sampling application can be identified by finding the option that deals with yes-no questions (e.g., is the invoice properly approved?).

#### 2. Situations where Sampling May Not Apply

Sampling concepts generally do not apply to:

a. Risk assessment procedures performed to obtain an understanding of internal control.

b. Tests of automated application controls when effective general controls are present. (Generally, such controls would only be tested once or a few times.)

c. Analyses of security and access controls, or other controls that do not provide documentary evidence of performance (e.g., controls related to segregation of duties).

d. Some tests related to the operation of the control environment or the accounting system (e.g., examination of the effectiveness of activities performed by those charged with governance).

## II. UNCERTAINTY AND AUDIT SAMPLING

### A. Audit Risk

*Audit risk* is the uncertainty inherent in applying audit procedures. Audit risk includes both:

1. uncertainties due to sampling; and
2. uncertainties due to factors other than sampling.

**Sampling Risk**

### B. Sampling Risk

Chance the sample is "wrong"

*Sampling risk* arises from the possibility that, when a test of controls or a substantive test is restricted to a sample, the auditor's conclusions may be different from the conclusions which would have been reached had the tests been applied to all items in the account balance or class of transactions.

1. **Sampling Risks in Substantive Testing** - Variables

In performing substantive tests of details, the auditor is concerned with two aspects of sampling risk.

a. **Risk of Incorrect Acceptance** Beta risk

Ineffective
Auditor concern

The *risk of incorrect acceptance* is the risk that the sample supports the conclusion that the recorded account balance is not materially misstated when in fact it is materially misstated (i.e., sample results fail to identify an existing material misstatement).

b. **Risk of Incorrect Rejection** Alpha risk

Inefficient

The *risk of incorrect rejection* is the risk that the sample supports the conclusion that the recorded account balance is materially misstated when in fact it is not materially misstated (i.e., sample results *mistakenly* indicate a material misstatement).

2. **Sampling Risks in Tests of Controls** - Attributes

In performing tests of controls, the auditor is also concerned with two aspects of sampling risk:

Overreliance

a. **Risk of Assessing Control Risk Too Low** Beta risk

Ineffective
Auditor concern

The *risk of assessing control risk too low* is the risk that the assessed level of control risk based on the sample is less than the true risk based on the actual operating effectiveness of the control (i.e., sample results indicate a lower deviation rate than actually exists in the population).

Underreliance

b. **Risk of Assessing Control Risk Too High** Alpha risk

Inefficient

The *risk of assessing control risk too high* is the risk that the assessed level of control risk based on the sample is greater than the true risk based on the actual operating effectiveness of the control (i.e., sample results indicate a greater deviation rate than actually exists in the population).

**PASS KEY**

Sampling risk can be thought of as the chance that, based on the results of a sample, the auditor will make a mistake. There are two primary mistakes the auditor can make: the auditor may fail to identify an existing problem (incorrect acceptance and assessing control risk too low), or the auditor may falsely identify a problem where none actually exists (incorrect rejection or assessing control risk too high).

3. **Efficiency** Lost with alpha risk

The risk of incorrect rejection and the risk of assessing control risk too high relate to the *efficiency* of the audit (the auditor does more audit work than is necessary). When the auditor's evaluation of an audit sample leads the auditor to this erroneous conclusion, the application of additional audit procedures and consideration of other audit evidence ordinarily leads the auditor to the correct conclusion.

Danger: could lead to an inappropriate opinion

4. **Effectiveness** Lost with beta risk -

The risk of incorrect acceptance and the risk of assessing control risk too low relate to the *effectiveness* of an audit in (possibly not) detecting an existing material misstatement. Auditors usually accept a risk of 5% or 10%. A related concept is that of confidence level (also called reliability). The auditor is 95% (or 90%) confident that the sample is representative of the population. (*Note:* Risk [of being ineffective] + confidence level = 100%.)

Inverse of the risk

5. **Summary Charts**

HW

The following two charts summarize the possible outcomes.

a. **Substantive Tests of Details** - Variable sampling

| | | *The recorded value of the population is:* | |
|---|---|---|---|
| | | OK | Not OK |
| *The sample indicates that the population is:* | OK | Correct decision | Incorrect decision<br>**Risk of Incorrect Acceptance**<br>Not effective Beta |
| | Not OK | Incorrect decision<br>**Risk of Incorrect Rejection**<br>Not efficient Alpha | Correct decision |

b. **Tests of Controls** - Attribute sampling

| | | *The true operation of the control is:* | |
|---|---|---|---|
| | | OK | Not OK |
| *The sample indicates that the control's operation is:* | OK | Correct decision | Incorrect decision<br>**Risk of Assessing Control Risk Too Low**<br>Not effective Beta |
| | Not OK | Incorrect decision<br>**Risk of Assessing Control Risk Too High**<br>Not efficient Alpha | Correct decision |

C. **Nonsampling Risk** Examples: 1) Use inappropriate audit evidence 2) Improperly evaluating the results

*Nonsampling risk* includes all aspects of audit risk that are not due to sampling. Nonsampling risk is always present and cannot be measured; the auditor can only attempt to reduce this risk to a very low level through adequate planning and supervision of the audit engagement and quality control of all firm practices. Examples of nonsampling risk are selecting audit procedures that are not appropriate to achieve a specific objective, or failure by the auditor to recognize misstatements in documents examined.

## III. SAMPLING IN TESTS OF CONTROLS: ATTRIBUTE SAMPLING

### A. Purpose

**Attribute Sampling**

*Attribute sampling* is a statistical sampling method used to estimate the rate (%) of occurrence (exception) of a specific characteristic (attribute). Samples taken to test the operating effectiveness of controls are intended to provide a basis for the auditor to conclude whether the controls are being applied as prescribed. Attribute sampling generally deals with yes/no questions. For example, *"Are time cards properly authorized (i.e., to assure recorded hours were worked)?"*, or *"Are invoices properly voided (e.g., stamped "paid") to prevent duplicate payments?"*

### B. Planning Considerations

When planning a particular audit sample for tests of controls, the auditor applies professional judgment in considering:

1. The relationship of the sample to the objective of the test of controls.

2. **Tolerable Deviation Rate** /Mistakes

   The *tolerable deviation rate* is the maximum rate of deviation from a prescribed procedure the auditor will tolerate without modifying planned reliance on internal control.

   a. In assessing the tolerable rate of deviation, the auditor should consider that, while deviations from pertinent controls increase the risk of material misstatements in the accounting records, such deviations do not necessarily result in misstatements.

3. The auditor's allowable risk of assessing control risk too low. Beta risk

4. Characteristics of the population (i.e., the expected or likely rate of deviation).

### C. Deviation Rate versus Tolerable Rate

1. **Deviation Rate**

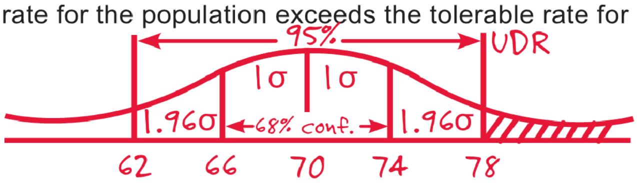
   The *deviation rate* in the sample is the auditor's best estimate of the deviation rate in the population from which it was selected.

**PASS KEY**

Students often mistakenly assume that the sample deviation rate also should be used as the estimated error rate in the total population. Consider the following example: Assume a population of 1,000 items, a sample of 100 items, and 7 deviations identified within the sample of 100 (a 7% sample deviation rate). While our best guess would be that there are 70 deviations in the entire population (also a 7% rate), it is unlikely that, if we were to individually examine each of those 1,000 items, we would find exactly 70 deviations. More likely, we might find 68, 69, 71, or 72 deviations. There are statistical formulae that determine whether the actual range is 68 to 72, 60 to 80, or something different, and there are tables available that provide the top end of the range. (As conservative auditors, we are concerned with the worst case scenario, so we generally don't bother with the low end of the range.) The top end of the range is formally known as the "upper deviation rate."

2. **Evaluation**

   If the estimated deviation rate is less than the tolerable rate for the population, the auditor should consider the risk that such a result might be obtained even though the true deviation rate for the population exceeds the tolerable rate for the population.



For example, assume the tolerable rate for a population is 5% and the sample consists of 60 items:

a. If no deviations are found in the sample of 60 items, the auditor may conclude that there is an acceptably low sampling risk that the true deviation rate in the population exceeds the tolerable rate of 5%. (This is because the sample deviation rate is much less than the tolerable rate.)

b. If the sample includes two or more deviations (2 in 60 = 3.33%), the auditor may conclude that there is an unacceptably high sampling risk that the rate of deviations in the population exceeds the tolerable rate of 5%. (This is because the sample deviation rate is close to the tolerable rate.)

c. The auditor applies professional judgment in making such evaluations.

**3. Conclusion**

If the auditor concludes that the sample results do not support the planned assessed level of control risk for an assertion, the nature, extent, and timing of substantive procedures should be reevaluated based on a revised consideration of the assessed level of control risk for the relevant financial statement assertions.

## D. Example - Steps for testing controls/attribute sampling

The auditor performs the following steps when conducting an attribute sampling application.

**1. Define the Objective of the Test**

Assume the auditor wants to determine the percentage of sales orders that are missing credit approval.

**2. Define the Population**

It must be appropriate for the objective. The period covered by the test should also be defined.

a. In this example, the population would consist of all sales orders used during the year.

b. If tests of controls are performed at an interim date, the auditor must perform such additional procedures as are necessary to obtain reasonable assurance regarding the remaining period.

**3. Define the Sampling Unit**

Consider the completeness of the population in defining the *sampling unit*.

a. Each sales order is a sampling unit.

b. The "population" must agree with the "physical representation." Completeness would be more assured by a register of prenumbered sales orders than by the physical file. For example, sales orders may be removed from the file, but the sales order number will be in the register. Note that the size of a population of consecutively numbered documents is the difference between the beginning and ending numbers plus one.

4. **Define the Attributes of Interest** * Only found in attribute sampling

Deviations are situations where the control was not properly applied, such as:

a. Missing credit approval.

b. Missing sales order (items that cannot be located are generally considered deviations).

5. **Determine the Sample Size**

The auditor must specify the following factors.

| Factor | Sample size |
|---|---|
| Want less risk | Larger |
| Accept more risk | Smaller |

a. **Risk of Assessing Control Risk Too Low**

This is the risk that the assessed level of control risk based on the sample is less than the true level of control risk based on the actual operating effectiveness of the control. There is an inverse relationship to sample size as the auditor is willing to accept greater risk, a smaller sample size can be used.

b. **Tolerable Deviation Rate**

Want less deviation Larger
Accept more deviation Smaller

**Tolerable Deviation Rate**

This is the maximum rate of error the auditor is willing to accept without changing control risk assessment or planned reliance on internal control. There is an inverse relationship to sample size as the auditor is willing to accept a greater deviation rate, a smaller sample size can be used.

c. **Expected Deviation Rate**

Expect less deviation Smaller
Expect more deviation Larger

This is the auditor's best estimate of the rate of deviation from a prescribed control procedure. There is a direct relationship to sample size as the auditor expects fewer deviations, a smaller sample size would be needed.

d. **Population Size**

*Population size* is not an issue provided the population is large (i.e., greater than 5,000 items).

e. **Sample Size Example**

Assume an auditor is testing the sales orders for credit approval deviations. Also assume the auditor is willing to accept a 5% risk of assessing control risk too low. The auditor expects a deviation rate of 1%, and the tolerable deviation rate is 6%. 95% confidence

Required:

(1) Determine the sample size using Table 1.

(2) Would the sample size increase or decrease if the expected deviation rate decreased to 0%? Smaller

(3) Would the sample size increase or decrease if the tolerable deviation rate increased to 7%? Smaller

(4) Would the sample size increase or decrease if the risk of assessing control risk too low increased to 10%? Smaller

| TABLE 1—ATTRIBUTE SAMPLE SIZE TABLE<br>5% RISK OF ASSESSING CONTROL RISK TOO LOW | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| *Expected Deviation Rate* | *Tolerable Rate* | | | | | | | | | | |
| | 2% | 3% | 4% | 5% | 6% | 7% | 8% | 9% | 10% | 15% | 20% |
| 0.00% | 149 | 99 | 74 | 59 | 49 | 42 | 36 | 32 | 29 | 19 | 14 |
| 0.50 | * | 157 | 117 | 93 | 78 | 66 | 58 | 51 | 46 | 30 | 22 |
| 1.00 | * | * | 156 | 93 | 78 | 66 | 58 | 51 | 46 | 30 | 22 |
| 1.50 | * | * | 192 | 124 | 103 | 66 | 58 | 51 | 46 | 30 | 22 |
| 2.00 | * | * | * | 181 | 127 | 88 | 77 | 68 | 46 | 30 | 22 |
| 3.00 | * | * | * | * | 195 | 129 | 95 | 84 | 61 | 30 | 22 |
| 4.00 | * | * | * | * | * | * | 146 | 100 | 89 | 40 | 22 |

## 6. Select the Sample

a. The most common technique is random selection, whereby each item in the population has an equal opportunity to be included in the sample.

b. Systematic selection (i.e., every nth item) is also acceptable, but a disadvantage is that results may be skewed if errors occur in a systematic pattern.

OK if random start

c. Block (cluster) sampling, where groups of adjacent items are selected, is not acceptable.

## 7. Evaluate the Sample Results - Apply "rules"

The auditor calculates the sample deviation rate and projects the results to the population. Table 2 is used to determine the upper deviation rate, which is based on the deviation rate in the sample plus an allowance for sampling risk.

a. Be sure to use a table that corresponds to the appropriate risk of assessing control risk too low (in this case, 5%).

b. Locate the sample size and the number of deviations found in the sample. The number at this intersection is the auditor's estimate of the maximum deviation rate in the population, or the upper deviation rate.

c. The upper (maximum) deviation rate is the sum of the sample deviation rate and the allowance for sampling risk. This allowance is a "cushion" for protection against undetected deviations.

| 70 | + | 8 | = | 78 |
|---|---|---|---|---|
| Sample deviation rate | + | Allowance for sampling risk | = | Upper deviation rate |

**PASS KEY**

Students often have trouble with the concepts of upper deviation rate and allowance for sampling risk, both of which have been tested on the exam. The allowance for sampling risk simply recognizes that it is likely that what we found in the sample isn't exactly what we would find in the population. Assume a population of 1,000 items, a sample of 100 items, and a sample deviation rate of 7% (7 deviations out of 100). If the upper deviation rate (from a table) is 8.5%, this implies a 1.5% allowance for sampling risk. Conversely, should the examiners provide the allowance for sampling risk (say, 2%), it would be added to the sample deviation rate (7%) to find an upper deviation rate of 9%.

**d. Evaluation Example**

Assume the auditor finds one sales order that is missing the proper credit approval in a sample of 100 sales orders (i.e., one deviation).

Required:

(1) Calculate the sample deviation rate. 1/100 = 1%

(2) Determine (from the table) the upper deviation rate. 4.7%

(3) What is the allowance for sampling risk? 3.7%

(4) Conclusion: The auditor is 95 % sure the deviation rate does not exceed 4.7 %.

| TABLE 2—ATTRIBUTE SAMPLE EVALUATION TABLE—UPPER DEVIATION RATE 5% RISK OF ASSESSING CONTROL RISK TOO LOW | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| *Sample Size* | *Actual Number of Deviations Found* | | | | | | | | | | |
| | 0 | 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 | 9 | 10 |
| 25 | 11.3 | 17.6 | * | * | * | * | * | * | * | * | * |
| 50 | 5.9 | 9.2 | 12.1 | 14.8 | 17.4 | 19.9 | * | * | * | * | * |
| 60 | 4.9 | 7.7 | 10.2 | 12.5 | 14.7 | 16.8 | 18.8 | * | * | * | * |
| 70 | 4.2 | 6.6 | 8.8 | 10.8 | 12.6 | 14.5 | 16.3 | 18.0 | 19.7 | * | * |
| 75 | 3.9 | 6.2 | 8.2 | 10.1 | 11.8 | 13.6 | 15.2 | 16.9 | 18.5 | 20.0 | * |
| 100 | 3.0 | 4.7 | 6.2 | 7.6 | 9.0 | 10.3 | 11.5 | 12.8 | 14.0 | 15.2 | 16.4 |
| 125 | 2.4 | 3.8 | 5.0 | 6.1 | 7.2 | 8.3 | 9.3 | 10.3 | 11.3 | 12.3 | 13.2 |
| 150 | 2.0 | 3.2 | 4.2 | 5.1 | 6.0 | 6.9 | 7.8 | 8.6 | 9.5 | 10.3 | 11.1 |

**8. Form Conclusions about the Internal Control Tested**

UDR $\leq$ TDR Rely

a. If the upper deviation rate is less than or equal to the auditor's tolerable deviation rate, the auditor may rely on the control (assuming the results of other audit tests do not contradict such results).

UDR $>$ TDR Do not rely

b. If the upper deviation rate exceeds the auditor's tolerable deviation rate, the auditor would not rely on the control. Instead, the auditor would either:

(1) Select and test compliance with some other internal accounting control, or

(2) Modify the nature, extent, or timing of related substantive tests to reflect the reduced reliance.

c. Conclusion example—assume the upper deviation rate has been determined to be 4.7%.

(1) If the tolerable rate is 3%, would the auditor rely on the control? $4.7 > 3$ - No

(2) If the tolerable rate is 6%, would the auditor rely on the control? $4.7 < 6$ - Yes

d. If the sample is representative of the population, the auditor will generally make a correct decision regarding whether or not the control is operating effectively.

e. If the sample is not representative of the population, the auditor will make an incorrect decision, either relying on a control that is not reliable, or not relying on a control that is reliable.

**PASS KEY**

The examiners sometimes try to trick candidates into using the sample deviation rate (instead of the upper deviation rate) in drawing conclusions about a population. In keeping with the concept of conservatism, auditors must consider the worst case scenario, or the high end of the range, in evaluating a population. It is therefore the upper deviation rate (and not the rate found in the sample) that is compared to the tolerable rate in developing conclusions.

9. **Document the Sampling Procedure**

Remember that as with all audit procedures, the auditor must document each step in audit sampling, starting with planning and including the rationale for the auditor's parameters, the performance of procedures, the observed results, and the evaluation and interpretation of those results.

## IV. OTHER ATTRIBUTE SAMPLING MODELS

### A. Discovery Sampling - Used for detecting fraud/critical items

*Discovery sampling* is a special type of attribute sampling appropriate when the auditor believes the population deviation rate is zero or near zero. It is used when the auditor is looking for a very critical characteristic (e.g., fraud). The auditor predetermines the desired reliability (confidence) level (e.g., 95%) and the maximum acceptable tolerable rate (e.g., 1%), and a table is then used to determine sample size.

If no deviations are found in the sample, the auditor can be 95% certain that the rate of deviation in the population does not exceed 1%. If deviations are found, a regular attribute sampling table may be used to estimate the deviation rate in the population, and audit procedures may need to be expanded.

### B. Stop-or-Go Sampling

*Stop-or-go sampling* (sequential sampling) is designed to avoid oversampling for attributes by allowing the auditor to stop an audit test before completing all steps. It is used when few errors are expected in the population.

## V. SAMPLING IN SUBSTANTIVE TESTS: VARIABLES SAMPLING

Or estimation sampling

**Variables Sampling**

### A. Purpose

Estimate $ value of the population

*Variables sampling* is a statistical sampling method used to estimate the numerical measurement of a population, such as a dollar value (e.g., accounts receivable balance). This sampling method is used primarily in substantive testing. The objective of variables sampling is to obtain evidence about the reasonableness of monetary amounts. The auditor estimates the true value of the population by computing a point estimate of the population and computing a precision interval around this point estimate.

## B. Planning Considerations

When planning a particular sample for a substantive test of details, the auditor should consider:

1. The relationship of the sample to the relevant audit objective.
2. Preliminary estimates of materiality levels.

Variable = Misstatements
Attribute = Deviations/errors

   **a. Tolerable Misstatement** - Desired precision - materiality

   *Tolerable misstatement* is the maximum monetary misstatement in the related account balance or class of transactions that the auditor is willing to accept.

| PASS KEY |
| --- |
| Tolerable misstatement is the application of performance materiality to a particular sampling procedure. Tolerable misstatement may be the same as performance materiality, or it may be an amount smaller than performance materiality if, for example, the population from which the sample is selected is smaller than the total account balance. |

3. The auditor's allowable risk of incorrect acceptance. - Confidence
   a. The audit risk model may be useful in establishing the allowable risk of incorrect acceptance.
4. Characteristics of the population.

## C. Sample Selection Considerations

The auditor uses professional judgment to determine which items should be subject to sampling. Certain items may be individually examined, such as those for which potential misstatements could individually exceed tolerable misstatement. 100% of such items are examined and they are not considered to be part of the sample.

Option
Stratification

Items subject to sampling may also be separated into relatively homogeneous groups. Each group is treated as a separate population. This technique, known as stratification, generally results in a reduced sample size. Stratification is commonly used when a population has highly variable recorded amounts.

| PASS KEY |
| --- |
| When stratification is used, each group is treated as a separate population. For example, assume 1,000 items are stratified into two groups: the 100 largest items will all be examined individually, but sampling techniques will be applied to the remaining 900 items. In this case, the population size for the sampling application would be 900, not 1,000. |

Rule 4: reduce variability = Smaller sample size

## D. Projected Misstatement vs. Tolerable Misstatement

### 1. Projected Misstatement

Upon completion of the sampling procedures, the auditor projects the misstatement results of the sample to the items in the population.

### 2. Evaluation

If the total projected misstatement is less than the tolerable misstatement for the account balance or class of transactions, the auditor should consider the risk that such a result might be obtained even though the true monetary misstatement for the population exceeds tolerable misstatement.

For example, assume the tolerable misstatement in an account balance of $1 million is $50,000:

a. If the total projected misstatement (based on the sample) is $10,000, the auditor may be reasonably assured that there is an acceptably low sampling risk that the true monetary misstatement for the population exceeds the tolerable misstatement of $50,000. (This is because $10,000 is significantly less than $50,000.)

b. If the total projected misstatement is close to the tolerable misstatement, the auditor may conclude that there is an unacceptably high risk that the actual error in the population exceeds the tolerable misstatement.

c. The auditor uses professional judgment in making such evaluations.

### 3. Conclusion

Projected misstatement results for all audit sampling applications and all known misstatements from non-sampling applications should be considered in the aggregate along with other relevant audit evidence when the auditor evaluates whether the financial statements taken as a whole may be materially misstated.

## E. Variables Sampling Plans

Classical variables sampling measures sampling risk by using the variation of the underlying characteristic of interest. There are three commonly used classical variables sampling plans.

### 1. Mean-per-Unit Estimation

Point est. = $\$250 \times 2{,}000 = \$500{,}000$

At $1\sigma = \$10 \times 2{,}000 = \pm \$20{,}000$

*Mean-per-unit (MPU) estimation* is a sampling plan that uses the average value of the items in the sample to estimate the true population value (i.e., estimate = average sample value x number of items in population). MPU does not require the book value of the population to estimate true population value.

### 2. Ratio Estimation

$\dfrac{\$25{,}000}{\$27{,}500} \times \$550{,}000 = \$500{,}000$ pt. estimate

*Ratio estimation* is a sampling plan that uses the ratio of the audited (correct) values of items to their book values to project the true population value. Ratio estimation is a highly efficient technique when the calculated audit amounts are approximately proportional to the client's book amounts.

### 3. Difference Estimation

$\dfrac{\$27{,}500 - \$25{,}000}{100} \times 2{,}000 = \$50{,}000$ adjustment required

*Difference estimation* is a sampling plan that uses the average difference between the audited (correct) values of items and their book values to project the actual population value. Difference estimation is used instead of ratio estimation when the differences are not nearly proportional to book values.

### 4. Comparison of Methods

a. MPU is very sensitive to the variability of the population. For that reason, when using MPU, auditors normally stratify (or divide) the population into relatively similar groups. The purpose of such stratification is to reduce sample size.

b. The ratio and difference methods usually require smaller sample sizes than the MPU method; however, they are only effective when the auditor expects large numbers of over- and understatements.

| Facts: | | | | |
|---|---|---|---|---|
| | Total book value | $550,000 | Population | 2,000 |
| | Selected items book value | $27,500 | Items selected | 100 |
| | Selected items true value | $25,000 | Selected items avg. value | $250 |
| | | | Std. error | $10 |

c. All three methods use the same sample size formulas and evaluation formulas. The sample size for the three methods varies because the standard deviations of the populations are calculated differently for each of the three methods.

## F. Example

Steps for substantive testing

The auditor must perform the following steps when conducting a variables sampling application.

### 1. Define the Objective of the Test

Assume the auditor wishes to estimate the value of an account balance (e.g., the client's accounts receivable balance).

### 2. Define the Population

It must be appropriate for the objective. Individually significant items should be identified for possible stratification.

a. In this example, the population might consist of 5,000 accounts with a recorded book value of $4,500,000.

b. The auditor would examine 100% of accounts for which potential errors could equal or exceed the tolerable error and would exclude those accounts from the population to be sampled.

### 3. Define the Sampling Unit

Consider the completeness of the population in defining the sampling unit.

a. In this case, each of the 5,000 accounts is a sampling unit.

### 4. Determine the Sample Size

a. The auditor uses the following parameters, in conjunction with tables or formulas, to determine sample size.

(1) Tolerable misstatement

(2) Expected misstatement (size, frequency, etc.)

(3) Acceptable level of risk: audit risk, risk of incorrect acceptance, and risk of incorrect rejection

(4) Characteristics of the population (e.g., an estimate of the standard deviation, or variability, of the population)

(5) Assessed risk: assessed risk of material misstatement (inherent risk and control risk) and assessed risk for other substantive procedures related to the same assertion

b. Sample size will increase/decrease by changing any of the items in the formula.

(1) Sample size will increase as the following increase (direct relationship):

(a) Expected misstatement

(b) Standard deviation (population variability)

(c) Assessed level of risk

(2) Sample size will decrease as the following increase (inverse relationship):

(a) Tolerable misstatement

(b) Acceptable level of risk

* Review for HW

**FACTORS INFLUENCING SAMPLE SIZES FOR TESTS OF DETAILS**

| *Factor* | *Conditions leading to* | | *Related factor for substantive sample planning* |
|---|---|---|---|
| | *Smaller sample size* | *Larger sample size* | |
| Assessment of inherent risk | Low assessed level of inherent risk | High assessed level of inherent risk | Allowable risk of incorrect acceptance |
| Assessment of control risk | Low assessed level of control risk | High assessed level of control risk | Allowable risk of incorrect acceptance |
| Assessment of risk for other substantive procedures related to the same assertion (including substantive analytical procedures and other relevant substantive procedures) | Low assessment of risk associated with other relevant substantive procedures | High assessment of risk associated with other relevant substantive procedures | Allowable risk of incorrect acceptance |
| Measure of tolerable misstatement for a specific account | Larger measure of tolerable misstatement | Smaller measure of tolerable misstatement | Tolerable misstatement |
| Expected size and frequency of misstatements | Smaller misstatements or lower frequency | Larger misstatements or higher frequency | Assessment of population characteristics |
| Number of items in the population | Virtually no effect on sample size, unless the population is very small | | |
| Choice between statistical and nonstatistical sampling | Ordinarily, sample sizes are comparable | | |

5. **Select the Sample**

   a. Sample items should be selected in such a way that the sample can be expected to be representative of the population (e.g., random sampling).

   b. In this example, an appropriate sample would consist of individual account balances. Confirmations could then be used to determine the audited values for sample items.

6. **Evaluate the Sample Results**

   The auditor projects the misstatements found in the sample to the population using one of several methods (e.g., MPU, ratio, difference, etc.). The projected misstatement is applied to the recorded balance to obtain a "point estimate" of the true balance. As shown below, the different methods result in different projected misstatements.

   a. **Evaluation Example**

   Assume that from the population of 5,000 accounts with a total value of \$4,500,000, the auditor selects a sample of 200 accounts with a book value of \$184,200. The audited value of these accounts based on confirmation results is \$175,000, with an average value of \$875 (\$175,000 / 200) per account.

*Mean-Per-Unit Estimation*

$875 average value x 5,000 accounts = $4,375,000 point estimate

*Ratio Estimation*

$$\frac{\$175{,}000 \text{ audited value}}{\$184{,}200 \text{ book value}} \times \$4{,}500{,}000 = \$4{,}275{,}244 \text{ point estimate}$$

*Difference Estimation*

$$\frac{\$184{,}200 \text{ book value} - \$175{,}000 \text{ audited value}}{200} \times 5{,}000 = \$230{,}000 \text{ projected error}$$

$4,500,000 - $230,000 = $4,270,000 point estimate

The auditor must then add an allowance for sampling risk (sometimes called a "precision interval") to the point estimate.

**7. Form Conclusions about the Balances (or Transactions) Tested**

Qualitative considerations

Error or fraud

a. In deciding whether to accept the client's book value, the auditor determines whether the recorded book value falls within the acceptable range (i.e., the point estimate +/- the allowance for sampling risk). If so, the book value is fairly stated.

b. The auditor's treatment of items selected for sampling that cannot be located (e.g., are "lost") will depend on their effect on the auditor's evaluation of the sample.

(1) If considering the missing items to be misstated would not alter the auditor's evaluation of the sample results, it is not necessary to examine the items.

(2) If considering the missing items to be misstated would lead to the conclusion that the balance or class contains a material misstatement, the auditor should consider alternative procedures.

c. If the sample is representative of the population, the auditor generally will make a correct decision regarding whether the account balance is fairly stated.

d. If the sample is not representative of the population, the auditor will make an incorrect decision, either accepting a materially misstated balance, or rejecting a fairly stated balance.

**8. Document the Sampling Procedure**

Remember that as with all audit procedures, the auditor must document each step in audit sampling, starting with planning and including the rationale for the auditor's parameters, the performance of procedures, the observed results, and the evaluation and interpretation of those results.

## VI. SAMPLING IN SUBSTANTIVE TESTS: PROBABILITY-PROPORTIONAL-TO-SIZE (PPS) SAMPLING

Also called: $ unit sampling

### A. PPS Sampling

PPS Sampling

PPS sampling is a technique where the sampling unit is defined as an individual dollar in a population. Once a dollar is selected, the entire account (containing that dollar) is audited. PPS sampling is considered to be a hybrid method, because it uses attribute sampling theory to express a conclusion in dollar amounts rather than as a rate of occurrence.

### B. Advantages of PPS Sampling

Automatically

1. PPS automatically emphasizes larger items by stratifying the sample. The chance of an item being selected is proportionate to its dollar amount.
2. If no errors are expected, PPS sampling generally requires a smaller sample than other methods.

### C. Disadvantages of PPS Sampling

A disadvantage of PPS sampling is that zero balances, negative balances, and understated balances generally require special design considerations.

### D. PPS Sample Size Determination

The auditor selects a PPS sample by dividing the total number of dollars in the population (book value) into uniform groups of dollars or intervals. The auditor then selects a logical unit (the balance that includes the selected dollar) from each sampling interval.

The sampling interval is determined as follows:

$$\text{Sampling interval} = \frac{\text{Tolerable misstatement}}{\text{Reliability factor}}$$

- From table

The sample size is determined as follows:

$$\text{Sample size} = \frac{\text{Recorded amount of the population}}{\text{Sampling interval}}$$

1. Tolerable misstatement is the maximum dollar error that may exist in the account without causing the financial statements to be materially misstated.
2. Reliability factors correspond to the risk of incorrect acceptance and are generally obtained from a table.
3. The above formula assumes that the auditor's expected misstatement is zero. Otherwise, a more complex version of the formula is required.

## E. Example

With zero expected errors, the reliability factors are as follows:

| Risk of Incorrect Acceptance | Reliability Factor |
|---|---|
| 1% | 4.6 |
| 5% | 3.0 |
| 10% | 2.3 |

Assume the auditor assesses tolerable misstatement at $15,000 and the risk of incorrect acceptance at 5%. The recorded amount (book value) of the population is $500,000.

1 Sampling interval = $15,000/3 = $5,000 ← Every $5,000th

2 Sample size = $500,000/$5,000 = 100

## F. Sample Selection

A random number between 1 and the sampling interval (inclusive) is selected. This number is the random start, and it will also determine the first item selected. Systematic selection is then used to select the remainder of the sample. The recorded amounts of the logical units (e.g., account balances) throughout the population are added and individual dollars are selected based on the interval. Once a dollar in an account is selected, that entire account will be audited.

### 1. Example

Assume the random start is 300 and the sampling interval is 5,000. Every 5,000th dollar will be selected, so the auditor will select the accounts that contain dollars 300; 5,300; 10,300; 15,300; 20,300; 25,300; etc.

| *Customer Account* | *Book Value* | *Cumulative Total* | Includes |
|---|---|---|---|
| 1 | 150 | 150 | |
| 2 | 800 | 950* | $300 |
| 3 | 1,400 | 2,350 | |
| 4 | 4,350 | 6,700* | $5,300 |
| 5 | 2,300 | 9,000 | |
| 6 | 4,900 | 13,900* | $10,300 |
| 7 | 8,500 | 22,400* | $15,300<br>$20,300 |
| 8 | 990 | 23,390 | |
| 9 | 1,000 | 24,390 | |
| 10 | 1,500 | 25,890* | $25,300 |
| | etc... | etc... | |
| 900 | 1,000 | 500,000 | |

*Note:* Using this methodology, all account balances greater than the interval are automatically selected.

* Accounts including the selected dollars would be included in the sample.

### G. Evaluation of Sample Results

If no errors are found in the sample, the error projection is zero and the allowance for sampling risk would not exceed the auditor's tolerable error. As a result, the auditor would generally conclude that the recorded balance is fairly stated.

If, on the other hand, errors are found in an account, the errors need to be projected to the interval as illustrated below. If the account selected has a balance greater than the interval, the actual dollar amount of the error should be used.

#### 1. Example

| "A" Recorded Amount | "B" Audit Amount | Tainting | | | | | Sample Interval | Projected Error |
|---|---|---|---|---|---|---|---|---|
| | | A-B | / | A | | % | | |
| $ 800 | $ 600 | $200 | | $800 | | 25% | $5,000 | $1,250 |
| $4,350 | $4,350 | | | $4,350 | | 0% | $5,000 | 0 |
| $4,900 | $ 0 | $4,900 | | $4,900 | | 100% | $5,000 | $5,000 |
| $8,500 | $6,900 | $1,600 | | | | | n/a | $1,600 |
| $1,500 | $1,200 | $300 | | $1,500 | | 20% | $5,000 | $1,000 |
| Projected Error | | | | | | | | $8,850 |

Note that, as with other variables sampling plans, an allowance for sampling risk would be calculated and added to the projected error, and the result would be compared to the tolerable misstatement.

## VII. QUALITATIVE CONSIDERATIONS

For all types of sampling, the auditor should consider qualitative aspects of deviations. These include:

### A. The Nature and Cause of Deviations

Deviations may be caused by errors, which are unintentional, or fraud, which is intentional.

### B. The Possible Relationship of Deviations to Other Phases of the Audit

The discovery of fraud ordinarily requires a broader consideration of possible implications than does the discovery of an error.

## VIII. DUAL-PURPOSE SAMPLES

In some instances, the auditor may use the same sample to perform both tests of controls and tests of details. *Dual-purpose samples* are generally used only when the auditor believes that there is an acceptably low risk that the deviation rate in the population exceeds the tolerable rate. The size of a sample designed for dual purposes should be the larger of the samples that would otherwise have been designed for the two separate purposes.

In evaluating dual-purpose samples, deviations from the control and monetary misstatements should be evaluated separately using the appropriate risk levels. The auditor should consider whether the existence of misstatements is indicative of a control failure; however, the absence of monetary misstatements does not necessarily imply that controls are operating effectively.

# INTERNAL CONTROL COMMUNICATIONS

## I. OVERVIEW

### A. Applicability

An accountant communicates internal control-related matters in the following situations:

1. **Financial Statement Audit** *(nonissuers)* Private company

   a. Although the purpose of an audit of a nonissuer is to express an opinion on the financial statements and not to express an opinion on the effectiveness of internal control, certain deficiencies related to internal control may be noticed by the auditor during the audit. Such deficiencies create a reporting responsibility for the auditor.

   b. This situation is governed by Statements on Auditing Standards (SAS).

2. **Integrated Audits** *(nonissuers and issuers)*

   **a. Examination of Internal Control** *(nonissuers)* Private company

   (1) An auditor may be hired to perform an examination of a nonissuer's internal control. The examination of internal control should be integrated with an audit of the entity's financial statements.

   (2) This situation is governed by Statements on Standards for Attestation Engagements (SSAE).

   **b. Audit of Internal Control** *(issuers)* Public company - required by SOX PCAOB #5

   (1) All issuers are required to have an audit of internal control over financial reporting that is integrated with an audit of the financial statements.

   (2) This situation is governed by Public Company Accounting Oversight Board (PCAOB) auditing standards.

### B. Definitions

Certain definitions are virtually the same for all three types of engagements. (Where slight differences exist, wording used for nonissuers is shown in **bold**; wording for issuers is shown in [brackets].)

1. **Control Deficiency**

Control Deficiency

A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to **prevent, or detect and correct** [prevent or detect] misstatements on a timely basis.

   a. A deficiency in design occurs when a necessary control is missing or when an existing control does not achieve the desired objective.

   b. A deficiency in operation occurs when a properly designed control does not operate as designed, or is performed by an inappropriate person.

2. **Material Weakness** = Worse

Material Weakness

A material weakness is a deficiency, or a combination of deficiencies, in internal control [over financial reporting], such that there is a reasonable possibility that a material misstatement of the **entity's** [company's annual or interim] financial statements will not be **prevented, or detected and corrected** [prevented or detected] on a timely basis.

a. "Reasonable possibility" implies that the likelihood of an event is either "reasonably possible" or "probable."

| U.S. AUDITING STANDARDS VS. INTERNATIONAL STANDARDS ON AUDITING |
| --- |
| * ISAs do not define the term material weakness. This term is defined in both the AICPA and PCAOB auditing standards. |

3. **Significant Deficiency** = Bad

Significant Deficiency

A significant deficiency is a deficiency, or a combination of deficiencies, in internal control [over financial reporting] that is less severe than a material weakness, yet important enough to merit attention by those **charged with governance** [responsible for oversight of the company's financial reporting].

## C. Examples of Control Deficiencies

Examples of control deficiencies that may be significant deficiencies or material weaknesses include:

1. Deficiencies in the design of controls, such as:
   a. Inadequate design of internal control over the preparation of financial statements or over a significant account or process.
   b. Insufficient control consciousness.
   c. Lack of appropriate controls over segregation of duties or safeguarding of assets.
   d. Inadequate design of IT controls.
   e. Lack of appropriate qualifications or training of client personnel.
   f. Inadequate design of monitoring controls or the absence of an appropriate process to report control deficiencies.
   g. Inadequate documentation of the components of internal control.
2. Failure in the operation of controls, such as evidence of:
   a. Failure in the operation of an effectively designed control over a significant account or process (for example, failure to obtain appropriate authorization for significant disbursements, to perform reconciliations or to safeguard assets).
   b. Undue bias or lack of objectivity.
   c. Misrepresentation by client personnel to the auditor.
   d. Management override of controls.
   e. Failure of an application control caused by a deficiency of a general control.
   f. An observed deviation rate that exceeds the auditor's expected rate.
   g. Failure of the information and communication component of internal control to provide complete, accurate, and timely information.

### D. Indicators of Material Weakness

Although there are three distinct sets of standards with respect to internal control communications, they all provide the same guidance with respect to evaluation of control weaknesses. The following situations are considered indicators of a material weakness in internal control.

1. Identification of any level of fraud (even immaterial fraud) perpetrated by senior management.
2. Restatement of previously issued financial statements to correct a material misstatement.
3. Identification by the auditor of a material misstatement that would not have been detected by the entity's internal control.
4. Ineffective oversight by **those charged with governance** (the company's audit committee).

## II. NONISSUERS: INTERNAL CONTROL MATTERS NOTED DURING AN AUDIT

### A. Responsibility of the Auditor

The auditor has a responsibility to evaluate control deficiencies identified during the audit and, in some cases, to report those deficiencies.

#### 1. Detection of Control Deficiencies

An auditor of financial statements is not required to perform procedures to identify deficiencies in internal control, or to express an opinion on the effectiveness of internal control. The auditor may, however, become aware of control deficiencies while performing the audit.

**PASS KEY**

The auditor may discuss relevant facts and circumstances with management when determining whether the auditor has identified internal control deficiencies. The level of management with whom it is appropriate to discuss the findings is one that is familiar with the internal control area concerned and that has authority to take remedial action. However, when findings call into question management's integrity or competence, it may not be appropriate to discuss the findings directly with management.

#### 2. Evaluation of Control Deficiencies

The auditor must evaluate control deficiencies (both individually and in combination) to determine whether they represent significant deficiencies or material weaknesses.

a. The severity of a deficiency, or a combination of deficiencies depends on not only whether a misstatement has actually occurred, but also on:

   (1) the magnitude of the potential misstatement; and

   (2) whether there is a reasonable possibility that the entity's controls will fail to prevent, or detect and correct, a misstatement of an account balance or disclosure.

**PASS KEY**

Significant deficiencies and material weaknesses may exist even though the auditor has not identified misstatements during the audit.

b. The auditor should consider both the likelihood and the magnitude of potential misstatements.

(1) *Likelihood*—Is there a reasonable possibility that the entity's controls will fail to prevent, or detect and correct, the misstatement? Consider the nature of the related accounts (e.g., susceptibility to fraud, subjectivity, complexity, etc.).

(2) *Magnitude*—Consider both the dollar amount and the volume of activity in accounts exposed to the deficiency.

c. If more than one control deficiency affects the same account balance or disclosure, individually insignificant deficiencies may, in combination, constitute a significant deficiency or material weakness.

d. The auditor should consider whether any controls tend to compensate for the identified deficiency. A compensating control is one that limits the severity of a control deficiency, and may prevent it from being identified as a significant deficiency or material weakness.

e. **Indicators of Material Weakness**

As indicated above, indicators of material weaknesses include senior management fraud, restatement of previous financial statements to correct a material error, identification by the auditor of a material misstatement that the entity's controls would not have detected, and ineffective oversight by those charged with governance.

3. **Communication of Control Deficiencies** In writing

Significant deficiencies and material weaknesses, even those that were corrected during the audit, must be communicated on a timely basis in writing to management and those charged with governance.

| U.S. AUDITING STANDARDS VS. INTERNATIONAL STANDARDS ON AUDITING |
|---|
| Because the ISAs do not define the term material weakness, the ISAs do not contain a requirement to separately identify and communicate material weaknesses. |

a. **Previously Existing Deficiencies** - Tell them again

Previously communicated significant deficiencies and material weaknesses that have not been corrected should be communicated again, in writing, during the current audit by referring to the previously issued written communication and the date of that communication.

b. **Timing**

Recommended: by report release

Required: release + 60

(1) While it is recommended that the written communication be made by the report release date, a window extending 60 days beyond this date is acceptable.

(2) Earlier communication (i.e., during the audit) is also acceptable. While such early communication need not be in writing, it does not negate the requirement for eventual written communication of all significant deficiencies and material weaknesses..

c. **Management's Evaluation**

It is management's responsibility to evaluate and address control deficiencies. Management may decide to accept certain significant deficiencies or material weaknesses based on the costs that would be incurred to correct them. Even in such situations, the auditor is still required to communicate such deficiencies in writing.

### d. Communication of Other Deficiencies

The auditor should communicate to management only, in writing or orally, other deficiencies in internal control identified during the audit that are of sufficient importance to merit management's attention but that are not significant deficiencies or material weaknesses. If other deficiencies are communicated orally, the communication should be documented.

| U.S. AUDITING STANDARDS VS. INTERNATIONAL STANDARDS ON AUDITING |
|---|
| ISAs do not explicitly require the auditor to document the communication of other deficiencies when the other deficiencies are communicated orally to management. |

(1) If the auditor has communicated other deficiencies in a prior period and management has chosen not to correct the deficiencies for cost or other reasons, the auditor need not repeat the communication in the current period.

(2) The auditor is not required to repeat information about other deficiencies if the information has already been communicated to management by other parties, such as internal auditors or regulators.

(3) The auditor may communicate the details of other deficiencies to those charged with governance, either orally or in writing, if those charged with governance wish to be made aware of the details or if the auditor chooses to inform them.

HW

### e. Summary Chart

| COMMUNICATION OF DEFICIENCIES IN INTERNAL CONTROL (Financial Statement Audit Only: Nonissuer) | | | | |
|---|---|---|---|---|
| | *Communicate the deficiency **to management only**, either orally or in writing.* | ***Communicate** the deficiency **to management**, in writing.* | *Communicate the deficiency **to those charged with governance**, in writing.* | ***Communication** should be made **within 60 days of the report release date.*** |
| Control deficiency | ✓ | | | ✓ |
| Significant deficiency | | ✓ | ✓ | ✓ |
| Material weakness | | ✓ | ✓ | ✓ |

## B. Communication Requirements

### 1. Communication Content

The written communication of significant deficiencies and material weaknesses should include the following:

a. The definition of the term material weakness and, when relevant, the definition of the term significant deficiency.

b. A description of the significant deficiencies and material weaknesses, including an explanation of their potential effects.

(1) The auditor does not need to quantify the potential effects.

(2) Potential effects can be described in terms of the control objectives and types of errors the control was designed to prevent, or detect and correct, or in terms of the risks of misstatement that the control was designed to address.

c. Sufficient information to enable those charged with governance and management to understand the context of the communication, including statements that:

(1) The purpose of the audit was for the auditor to express an opinion on the financial statements.

(2) The audit included consideration of internal control over financial reporting in order to design audit procedures that are appropriate in the circumstances but not for the purpose of expressing an opinion on the effectiveness of internal control.

(3) The auditor is not expressing an opinion on the effectiveness of internal control.

(4) The auditor's consideration of internal control was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies, and therefore, material weaknesses and significant deficiencies may exist that were not identified.

d. A restriction regarding the use of the communication to management, those charged with governance, others within the organization, and any governmental authority to which the auditor is required to report.

**U.S. AUDITING STANDARDS VS. INTERNATIONAL STANDARDS ON AUDITING**

ISAs *do not* require the following elements that are required in the written communication under U.S. auditing standards:

- The definition of material weakness, and when relevant, the definition of significant deficiency
- An explanation that the auditor is not expressing an opinion on the effectiveness of internal control
- An explanation that the auditor's consideration of internal control was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies
- A statement restricting the use of the communication to management, those charged with governance, others within the organization, and any governmental authority to which the auditor is required to report

### 2. Optional Communication Content

The auditor may also include the following information in the communication when appropriate:

a. A description of the inherent limitations of internal control.

b. The specific nature and extent of the auditor's consideration of internal control during the audit.

### 3. Absence of Significant Deficiencies or Material Weaknesses

a. The auditor may not report the absence of significant deficiencies, since there is too great a potential for misinterpretation of the very limited degree of assurance the auditor would be providing in such instances.

b. The auditor may issue a communication indicating that no material weaknesses were identified during the audit, typically for the client to submit to governmental authorities.

**U.S. AUDITING STANDARDS VS. INTERNATIONAL STANDARDS ON AUDITING**

ISAs do not address the issuance of communications indicating no material weaknesses or no significant deficiencies.

① Done/fixed
② Plan to fix
③ Cost/benefit - do not fix

4. **Management's Written Response**

Management may prepare a written response to the auditor's communication regarding significant deficiencies and material weaknesses identified during the audit. Management's response may describe corrective actions taken or planned for the future, or indicate that the cost of correcting the identified deficiencies would exceed the benefits to be derived.

a. If such response is included in a document containing the auditor's written communication, the auditor may add a paragraph disclaiming an opinion on management's response.

5. **Sample Written Communication**

To Management and [*identify the body or individuals charged with governance*] of ABC Company:

In planning and performing our audit of the financial statements of ABC Company (the "Company") as of and for the year ended December 31, 20XX, in accordance with auditing standards generally accepted in the United States of America, we considered the Company's internal control over financial reporting (internal control) as a basis for designing audit procedures that are appropriate in the circumstances for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control. Accordingly, we do not express an opinion on the effectiveness of the Company's internal control.

Our consideration of internal control was for the limited purpose described in the preceding paragraph and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies and therefore, material weaknesses or significant deficiencies may exist that were not identified. However, as discussed below, we identified certain deficiencies in internal control that we consider to be material weaknesses and significant deficiencies.

A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, misstatements on a timely basis. A material weakness is a deficiency, or a combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis. We consider the following deficiencies in the Company's internal control to be material weaknesses:

Describe terms

[*Describe the material weaknesses that were identified and an explanation of their potential effects.*]

A significant deficiency is a deficiency, or combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance. We consider the following deficiencies in the Company's internal control to be significant deficiencies:

[*Describe the significant deficiencies that were identified and an explanation of their potential effects.*]

*[If the auditor is communicating significant deficiencies and did not identify any material weaknesses, the auditor may state that none of the identified deficiencies are considered to be material weaknesses.]*

Restricted use

This communication is intended solely for the information and use of management, [*identify the body or individuals charged with governance*], others within the organization, and [*identify any specified governmental authorities to which the auditor is required to report*] and is not intended to be, and should not be, used by anyone other than these specified parties.

*[Auditor's Signature]*

[*Date*]

## III. INTEGRATED AUDITS *(issuers and nonissuers)*

Under PCAOB standards, auditors of issuers are required to perform an integrated audit, auditing both the financial statements and management's assessment of the effectiveness of internal control over financial reporting. The audit of management's assessment is commonly referred to as an "audit of internal control over financial reporting."

| IMPACT OF THE DODD-FRANK ACT ON THE ISSUER INTEGRATED AUDIT REQUIREMENT |
|---|
| The Dodd-Frank Act amended Rule 404 of the Sarbanes-Oxley Act to provide that an audit of an issuer's internal control over financial reporting is only required for issuers that are large accelerated filers or accelerated filers. A large accelerated filer is defined by the SEC as an issuer with a worldwide market value of outstanding common equity held by non-affiliates of $700 million or more. An accelerated filer is defined as an issuer with a worldwide market value of outstanding common equity held by non-affiliates of $75 million or more, but less than $700 million. |

SSAEs allow an auditor to examine and report on a nonissuer's internal control over financial reporting that is integrated with a financial statement audit. The rules regarding the conduct of issuer and nonissuer integrated audits are very similar. The similarities and differences between the two sets of integrated audit standards are highlighted below.

### A. Objective of the Engagement *(issuers and nonissuers)*

The auditor's objective in an audit or examination of internal control is to express an opinion on the effectiveness of the entity's internal control over financial reporting. Because an entity's internal control cannot be considered effective if one or more material weaknesses exist, the auditor should plan and perform the engagement to obtain sufficient appropriate evidence to obtain reasonable assurance about whether material weaknesses exist as of the date specified in management's assertion.

### B. Conditions for Engagement Performance

1. **Auditor Requirements** *(issuers and nonissuers)*

   a. The audit or examination of internal control should be integrated with an audit of the financial statements. The auditor should plan and perform the integrated audit to achieve the objectives of both engagements.

   b. The auditor should use the same control criteria to perform the audit or examination of internal control as management uses for its evaluation of the effectiveness of the entity's internal control.

   c. Tests of controls should be designed to provide sufficient appropriate evidence to support both the opinion on internal control and the control risk assessment needed for the financial statement audit.

2. **Management Requirements** *(issuers only)* Public company

   Section 404 of the *Sarbanes-Oxley Act of 2002* requires each issuer's annual report to contain an internal control report that:

   a. states management's responsibility for establishing and maintaining an adequate internal control structure and procedures for financial reporting; and

   b. contains an assessment, as of the end of the most recent fiscal year of the issuer, of the effectiveness of the internal control structure and procedures of issuer for financial reporting.

3. **Management Requirements** *(nonissuers only)* Private company

An SSAE examination of internal control can only be performed if management:

a. Accepts responsibility for the effectiveness of internal control.

b. Evaluates the effectiveness of the entity's internal control using suitable and available criteria, such as criteria issued by the AICPA or by regulatory agencies.

c. Supports its assertion about the effectiveness of internal control with sufficient appropriate evidence.

(1) Management is responsible for identifying and documenting control objectives and the controls that meet those objectives.

(2) Management's monitoring activities may provide evidence supporting its assertion.

d. Provides a written assertion about the effectiveness of the entity's internal control in a report that accompanies the auditor's report.

(1) The "as of" date in management's assertion should coincide with the date of the financial statements.

Represents a scope limitation

(2) The auditor should withdraw from the engagement if management refuses to furnish a written assertion. (In rare instances, where the auditor is not permitted by law or regulation to withdraw, a disclaimer of opinion should be issued.)

4. **Written Representations** *(issuers and nonissuers)*

a. The auditor should obtain a written representation letter from management in which management:

(1) Acknowledges its responsibility for establishing and maintaining effective internal control, and states that management has performed an evaluation of the effectiveness of the entity's internal control.

(2) States the assertion and specifies the criteria used to evaluate the assertion.

(3) Affirms that management did not rely on the auditor's procedures as the basis for the assertion.

(4) Confirms that all significant deficiencies and material weaknesses have been disclosed to the auditor, and indicates whether any such deficiencies identified in previous engagements remain unresolved.

(5) Describes fraud resulting in material misstatement or fraud involving senior management or key employees.

(6) States whether there were any significant changes to internal control after the "as of" date of the report.

b. Failure to obtain such written representations is a scope limitation that will generally result in the auditor's withdrawal from the engagement or in a disclaimer of opinion.

## C. Planning the Engagement *(issuers and nonissuers)*

Planning involves developing an overall strategy for the scope and performance of the engagement. The auditor should consider:

1. Matters affecting the industry of the entity—reporting practices, economic conditions, laws and regulations, and technological change.
2. Prior knowledge of the entity's internal control (obtained during other professional engagements or by reviewing a predecessor's working papers).
3. Matters concerning the entity and its business—organization, operations, and capital structure.
4. The relative complexity of entity operations, as well as the extent of any recent changes in the entity, its operations, or its internal control.
5. Management's method of evaluating control effectiveness.
6. Judgments about materiality and risk, including risks evaluated as part of the auditor's acceptance and retention decision and preliminary judgments about the effectiveness of internal control.
    a. The same level of materiality and the same risk assessment process should be used for both the financial statement audit and the examination of internal control.
    b. More attention should be focused on areas of higher risk.
    c. The results of the fraud risk assessment performed in the financial statement audit should be considered in the examination of internal control, and the auditor should evaluate whether controls sufficiently address fraud risk.
7. Previously communicated deficiencies, legal or regulatory matters, and public information about the entity.
8. The nature and extent of available evidence.
9. **Scaling the Audit** For "small" public co./issuers - this is OK

    Smaller or less complex companies might achieve their control objectives differently than would more complex companies, so the audit should be scaled appropriately.
10. **Fraud Risk Assessment**

    The auditor's fraud risk assessment (required in the financial statement audit) should be integrated into the audit or examination of internal control, and the auditor should consider management fraud and management override of controls as areas of high risk. Controls that might address these risks include controls over:

    a. Significant or unusual transactions.
    b. Period-end journal entries and adjustments.
    c. Related party transactions.
    d. Significant management estimates.

    The auditor should also consider controls that mitigate incentives and pressures that may lead management to falsify or inappropriately manage financial results.

**11. Using the Work of Others** - OK for non high-risk areas

The auditor may use the work of others (internal auditors, other company personnel, and certain third parties) who are sufficiently competent and objective, in evaluating the effectiveness of internal control.

a. The auditor should consider the risk associated with a particular control, in determining whether and to what extent to use the work of others.

(1) As risk increases, a greater degree of competence and objectivity is required.

(2) For high-risk areas, use of the work of others might be reduced or eliminated.

## D. Top-down Approach *(issuers and nonissuers)*

A *top-down approach* is used in selecting controls to test. The auditor evaluates overall risks at the financial statement level, considers controls at the entity level, and then focuses on accounts, disclosures, and assertions for which there is a reasonable possibility of material misstatement.

### 1. Entity-level Controls

a. The auditor should identify and test entity-level controls that are important to the auditor's overall opinion about internal control. Entity-level controls include controls related to:

(1) The control environment

(2) Management override

(3) The company's risk assessment process

(4) Centralized processing

(5) Monitoring the results of operations

(6) Monitoring other controls

(7) Period-end financial reporting

(8) Policies that address significant business control and risk management practices

The control environment and the period-end financial reporting process are specifically identified within the professional standards as items of importance that should be evaluated.

b. The auditor's evaluation of entity-level controls can result in increasing or decreasing the testing that the auditor otherwise would have performed on other controls.

(1) Entity-level controls that are working effectively may allow the auditor to reduce the testing of lower level controls, or might affect the nature, extent, or timing of the auditor's tests of lower level controls.

**2. Identifying Accounts, Disclosures, and Assertions**

a. The auditor should evaluate qualitative and quantitative risk factors to identify significant accounts and disclosures, and their relevant assertions. Risk factors include:

(1) Account size and composition

(2) Susceptibility to misstatement

(3) Volume of activity, complexity, and homogeneity of transactions

(4) The nature of the account

(5) Accounting and reporting complexities

(6) Exposure to loss, or to the possibility of significant contingent liabilities

(7) The existence of related party transactions

(8) Changes from the prior period

b. In determining what amount of audit attention should be applied to a particular account, disclosure or assertion, the auditor should assess the risk that a material weakness in that area may exist, as well as the risk that such weakness will lead to a material misstatement in the financial statements.

(1) A greater risk implies that more audit attention should be applied, more evidence should be obtained, etc.

(2) A *walkthrough* (in which a transaction is followed from origination through financial recording) is one of the most effective ways to identify likely sources of potential misstatement.

c. The evaluation of risk factors is the same for both an audit of the financial statements and an examination of internal control.

**3. Selecting Controls to Test**

The auditor should test those controls that are important in addressing the risk of material misstatement.

**E. Testing Controls** *(issuers and nonissuers)*

**1. Tests of Controls**

In testing controls, the auditor should:

a. Evaluate the *design* effectiveness of the controls to determine whether the controls, if applied as prescribed, satisfy the company's control objectives and can effectively prevent or detect (and correct) material misstatements.

(1) Walkthroughs, which include inquiry, observation, and inspection of documentation, are often used to evaluate design effectiveness.

b. Test and evaluate the *operating* effectiveness of the controls to determine whether the controls are operating as designed, and whether the persons implementing the controls are qualified to implement them effectively.

(1) Operating effectiveness is typically tested through inquiry, inspection of documentation, observation, recalculation, and reperformance.

(2) Inquiry alone is not sufficient to support a conclusion about operating effectiveness.

c. Obtain relatively more evidence for controls that are subject to a greater risk of failure.

d. Obtain sufficient appropriate evidence to support the opinion about the overall effectiveness of the entity's internal control.

(1) The auditor is not responsible for obtaining sufficient evidence to support an opinion about the effectiveness of each individual control, but rather the effectiveness of the entity's internal control overall.

e. Determine the effect of any identified control deviations on the assessment of risk associated with the control, the amount of evidence to be obtained, and the operating effectiveness of the control.

(1) An individual control does not have to operate without any deviation to be considered effective.

f. Determine the appropriate timing for tests of controls.

(1) Tests performed over a longer period of time provide more evidence of effectiveness than tests performed over a shorter period of time.

(2) Tests performed closer to the date of management's assertion provide more evidence than testing performed earlier in the year. (Tests performed earlier in the year should be supplemented with additional evidence for the remainder of the year.)

(3) The auditor should use judgment in balancing the timing of tests.

g. Consider knowledge obtained during past examinations.

h. Incorporate an element of unpredictability into the testing.

**2. Use of Service Organizations**

A service organization may be part of an entity's internal control. In such cases, the auditor should:

a. Obtain an understanding of relevant controls.

b. Obtain evidence that the controls are operating effectively (by performing one or more of the following: obtaining a service auditor's report, testing the entity's controls over the activities of the service organization, and/or performing tests of controls at the service organization).

(1) If the date specified in management's assertion is significantly beyond the time period covered by the service auditor's report, the auditor should perform additional procedures.

(2) No reference should be made to the service auditor's report in the auditor's report on internal control.

3. **Benchmarking of Automated Controls**

   Automated application controls are not particularly susceptible to human error. If general controls with respect to program modifications, access, and operations are tested and continue to be effective, and if the automated controls have not changed from one year to the next, the auditor may not need to repeat specific testing performed in the previous year (but would need to verify that the control has not changed). This "benchmarking" strategy is most appropriate in low risk situations.

## F. Evaluating Control Deficiencies *(issuers and nonissuers)*

1. The auditor should determine whether identified deficiencies represent significant deficiencies or material weaknesses (either alone or in combination). This determination should be based on:
   a. The magnitude of the potential misstatement resulting from the deficiency; and
   b. The likelihood that the control will fail to prevent, or detect and correct, a material misstatement.
2. A control weakness may be a material weakness even if no misstatement actually occurred.
3. Compensating controls, if found to be operating effectively, may limit the severity of an identified deficiency and prevent it from being a material weakness.
4. **Indicators of Material Weakness**

   As indicated previously, indicators of material weaknesses include senior management fraud, restatement of previous financial statements to correct a material error, identification by the auditor of a material misstatement that the entity's controls would not have detected, and ineffective oversight by those charged with governance.

## G. Forming an Opinion *(issuers and nonissuers)*

1. The auditor should form an opinion about the effectiveness of internal control.
   a. The auditor should base this opinion on all available evidence, including both evidence obtained from the financial statement audit and evidence obtained during the examination of internal control.
2. After forming an opinion on the effectiveness of the entity's internal control over financial reporting, the auditor should evaluate management's report on internal control.
   a. Management's report should:
      (1) Indicate that management is responsible for internal control.
      (2) Describe the subject matter of the examination (e.g., controls over financial statement preparation).
      (3) Identify the criteria used by management to measure the effectiveness of the entity's internal control.
      (4) Include a statement of management's assertion about the effectiveness of internal control, including an "as of" date. For issuers, the "as of" date should be the end of the entity's most recent fiscal year.
      (5) Describe any material weaknesses identified by management.

b. If management's report is incomplete or improperly presented, the auditor should modify his or her own report to discuss the situation.

c. If the auditor determines that the required disclosures for one or more material weaknesses have not been included in management's report, this should be stated in the auditor's report. The auditor's report should include a description of each material weakness not included in management's report.

d. If management refuses to supply a report, the auditor should withdraw from the engagement.

e. **Other Information in Management's Report**

If management's report contains additional information beyond that noted above, the auditor should disclaim an opinion on such information. For example, if the report states that management believes the cost of correcting a weakness would exceed the benefits to be derived from implementing new policies and procedures, the auditor should disclaim an opinion on management's "cost-benefit statement":

> *"We do not express an opinion or any other form of assurance on management's cost-benefit statement."*

## H. Communications with Management and Those Charged with Governance

*(nonissuers only)*

1. The auditor should **communicate to management and those charged with governance, in writing, all significant deficiencies and material weaknesses** found during the examination of the internal controls of a nonissuer (including those that were previously communicated in writing, but which have not been corrected).

   a. Such communication generally should be made by the report release date.

   b. Significant deficiencies and material weaknesses that were previously communicated in writing, but which have not been corrected, may be communicated by referring to the previously issued written communication and the date of the communication.

   c. The auditor may choose to communicate significant matters earlier, during the course of the integrated audit, but this does not negate the requirement for a written communication, even if the deficiencies were corrected during the examination.

d. Sample communication:

> In connection with our audit of W Company's (the "Company") financial statements as of December 31, 20XX and for the year then ended, and our audit of the Company's internal control over financial reporting as of December 31, 20XX ("integrated audit"), the standards established by the American Institute of Certified Public Accountants require that we advise you of the following internal control matters identified during our integrated audit.
>
> Our responsibility is to plan and perform our integrated audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud, and whether effective internal control over financial reporting was maintained in all material respects (that is, whether material weaknesses exist as of the date specified in management's assertion). The integrated audit is not designed to detect deficiencies that, individually or in combination, are less severe than a material weakness. However, we are responsible for communicating to management and those charged with governance significant deficiencies and material weaknesses identified during the integrated audit. We are also responsible for communicating to management deficiencies that are of a lesser magnitude than a significant deficiency, unless previously communicated, and inform those charged with governance when such a communication was made.
>
> A deficiency in internal control over financial reporting exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct misstatements on a timely basis. [*A material weakness is a deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the Company's financial statements will not be prevented, or detected and corrected on a timely basis. We believe the following deficiencies constitute material weaknesses:*]
>
> [*Describe the material weaknesses that were identified during the integrated audit. The auditor may separately identify those material weaknesses that exist as of the date of management's assertion by referring to the auditor's report.*]
>
> [*A significant deficiency is a deficiency, or a combination of deficiencies, in internal control over financial reporting that is less severe than a material weakness, yet important enough to merit attention by those charged with governance. We consider the following deficiencies to be significant deficiencies:*]
>
> [*Describe the significant deficiencies that were identified during the integrated audit.*]
>
> This communication is intended solely for the information and use of management, [*identify the body or individuals charged with governance*], others within the organization, and [*identify any specified governmental authorities*] and is not intended to be and should not be used by anyone other than these specified parties.

Define & describe

Restricted use

2. The auditor should **communicate to management, in writing, all deficiencies** identified during the integrated audit (i.e., even those that do not rise to the level of being significant deficiencies or material weaknesses). This written communication should be made **no later than 60 days following the report release date**. The auditor should also **inform those charged with governance** when such a communication has been made. Deficiencies previously communicated in writing need not be repeated.

3. If the auditor concludes that the oversight of financial reporting and internal control by the company's audit committee (or similar body) is ineffective, the auditor must communicate that conclusion in writing to the board of directors.

4. The auditor is not required to search for control deficiencies that are less severe than a material weakness, but those that are identified should be reported.

5. An audit does not provide assurance that all deficiencies less severe than a material weakness have been identified, so the auditor should not issue a report stating that no such deficiencies were noted. The auditor also should not issue a report stating that no material weaknesses were identified.

HW 6. Summary chart:

Private company

who / when

**COMMUNICATION OF DEFICIENCIES IN INTERNAL CONTROL**
**(Examination Engagement: Nonissuer)**

| | ***Communicate*** *the deficiency* ***to management****, in writing.* | ***Communicate*** *the deficiency* ***to those charged with governance****, in writing.* | ***Communication*** *should be made* ***by the report release date****.* | ***Communication*** *should be made* ***within 60 days of the report release date****.* |
|---|---|---|---|---|
| Control deficiency | ✓ | | | ✓ |
| Significant deficiency | ✓ | ✓ | ✓ | |
| Material weakness | ✓ | ✓ | ✓ | |

## I. Communications with Management and the Audit Committee *(Issuers Only)*

1. The auditor **must communicate, in writing, to management and the audit committee, all material weaknesses** identified during the audit. The written communication should be made **prior to the issuance of the auditor's report on internal control** over financial reporting.

2. The auditor is required to **communicate any identified significant deficiencies, in writing, to the audit committee**.

3. The auditor should **communicate to management, in writing, all deficiencies in internal control** over financial reporting (i.e., those deficiencies in internal control over financial reporting that are of a lesser magnitude than material weaknesses) identified during the audit **and inform the audit committee** when such a communication has been made.

4. If the auditor concludes that the oversight of financial reporting and internal control by the company's audit committee is ineffective, the auditor must communicate that conclusion in writing to the board of directors.

5. The auditor is not required to search for control deficiencies or significant deficiencies, but those that are identified should be communicated.

6. An audit does not provide assurance that all control deficiencies or all significant deficiencies have been identified, so the auditor should not issue a report stating that no such deficiencies were noted.

7. The PCAOB has not provided sample communications to management or the audit committee.

HW 8. Summary chart:

Public company

| COMMUNICATION OF DEFICIENCIES IN INTERNAL CONTROL (ISSUER) | | | |
|---|---|---|---|
| | ***Communicate** the deficiency to **management**, in writing, and inform the audit committee that this communication has been made.* | ***Communicate** the deficiency **to the audit committee**, in writing.* | ***Communication** (to management and the audit committee) should be made **prior to the issuance of the auditor's report** on internal control.* |
| Control deficiency | ✓ | | |
| Significant deficiency | ✓ | ✓ | |
| Material weakness | ✓ | ✓ | ✓ |

## J. Reporting on Internal Control *(Nonissuers)*

Under SSAEs, the auditor may report directly on the effectiveness of the entity's internal control, or may report on management's assertion with respect to internal control.

### 1. Opinion Directly on Internal Control

Independent Auditor's Report

[*Introductory paragraph*]

We have examined W Company's internal control over financial reporting as of December 31, 20XX, based on [*identify criteria**]. W Company's management is responsible for maintaining effective internal control over financial reporting, and for its assertion of the effectiveness of internal control over financial reporting, included in the accompanying [*title of management's report*]. Our responsibility is to express an opinion on W Company's internal control over financial reporting based on our examination.

[*Scope paragraph*]

We conducted our examination in accordance with attestation standards established by the American Institute of Certified Public Accountants. Those standards require that we plan and perform the examination to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our examination included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our examination also included performing such other procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion.

[*Definition paragraph*]

An entity's internal control over financial reporting is a process affected by those charged with governance, management, and other personnel, designed to provide reasonable assurance regarding the preparation of reliable financial statements in accordance with [*applicable financial reporting framework, such as accounting principles generally accepted in the United States of America*]. An entity's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with [*applicable financial reporting framework, such as accounting principles generally accepted in the United States of America*], and that receipts and expenditures of the entity are being made only in accordance with authorizations of management and those charged with governance; and (3) provide reasonable assurance regarding prevention, or timely detection and correction of unauthorized acquisition, use, or disposition of the entity's assets that could have a material effect on the financial statements.

(continued)

(continued)

[*Inherent limitations paragraph*]

Because of its inherent limitations, internal control over financial reporting may not prevent, or detect and correct misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

[*Opinion paragraph*]

In our opinion, W Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 20XX, based on [*identify criteria*].

[*Audit of financial statements paragraph*]

We also have audited, in accordance with auditing standards generally accepted in the United States of America, the [*identify financial statements*] of W Company and our report dated [date of report, which should be the same as the date of the report on the examination of internal control] expressed [*include nature of opinion*].

[*Signature*]

[*Date*]

* For example, "criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."

**

**PASS KEY**

The examiners have focused many questions in prior exams on the "Inherent Limitations Paragraph."

## 2. Opinion on Management's Assertion

A report on management's assertion would be the same as the report shown above, with the following revisions:

[*Introductory paragraph*]

We have examined management's assertion, included in the accompanying [*title of management report*], that W Company maintained effective internal control over financial reporting as of December 31, 20XX based on [*identify criteria*]...

...our responsibility is to express an opinion on management's assertion based on our examination.

[*Opinion paragraph*]

In our opinion, management's assertion that W company maintained effective internal control over financial reporting as of December 31, 20XX is fairly stated, in all material respects, based on [*identify criteria*].

## 3. Separate or Combined Reports

The auditor is required to report on both the company's financial statements and on its internal control over financial reporting. Two separate reports, or one combined report (that is, one report containing both an opinion on the financial statements and an opinion on internal control), may be issued.

### a. Separate Reports

If separate reports are issued, each report should contain an explanatory paragraph making reference to the other report and indicating the nature of the opinion expressed.

A sample separate report on internal controls is shown in Item 1. "Opinion Directly on Internal Control." This report includes the following wording:

> [*Add to the report on internal control*]
>
> We also have audited, in accordance with auditing standards generally accepted in the United States of America, the [*identify financial statements*] of W Company and our report dated [*date of report, which should be the same as the date of the report on internal control*] expressed [*include nature of opinion*].

The following wording should be added to the separate report on the financial statements:

> [*Add to the report on the financial statements*]
>
> We also have examined [*or audited*], in accordance with attestation standards established by the American Institute of Certified Public Accountants, W Company's internal control over financial reporting as of December 31, 20XX, based on [*identify control criteria*] and our report dated [*date of report, which should be the same as the date of the report on the financial statements*] expressed [*include nature of opinion*].

**b. Sample Combined Report Expressing an Unqualified Opinion on Internal Control and an Unmodified Opinion on the Financial Statements** *(nonissuer)*

> **Independent Auditor's Report**
>
> [*Appropriate addressee*]
>
> We have audited the financial statements of W Company, which comprise the balance sheet as of December 31, 20XX, and the related statements of income, changes in stockholder's equity, and cash flows for the year then ended, and the related notes to the financial statements. We also have audited W Company's internal control over financial reporting as of December 31, 20XX, based on [*identify criteria*].
>
> [*Management's responsibility*]
>
> W. Company's management is responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America, for maintaining internal control over financial reporting including the design, implementation, and maintenance of controls relevant to the preparation and fair presentation of these financial statements that are free from material misstatement, whether due to error of fraud, and for its assertion about the effectiveness of internal control over financial reporting, included in the accompanying [*title of management's report*].
>
> [*Auditor's responsibility*]
>
> Our responsibility is to express an opinion on these financial statements and an opinion on W Company's internal control over financial reporting based on our audits. We conducted our audit of the financial statements in accordance with auditing standards generally accepted in the United States of America and our audit of internal control over financial reporting in accordance with attestation standards established by the American Institute of Certified Public Accountants. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects.
>
> (continued)

(continued)

An audit of financial statements involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances. An audit of internal control over financial reporting involves obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audits also included performing such other procedures as we considered necessary in the circumstances.

We believe that the audit evidence we obtained is sufficient and appropriate to provide a basis for our audit opinions.

[*Definitions and inherent limitations of internal control paragraph*]

An entity's internal control over financial reporting is a process effected by those charged with governance, management, and other personnel, designed to provide reasonable assurance regarding the preparation of reliable financial statements in accordance with [*applicable financial reporting framework, such as accounting principles generally accepted in the United States of America*]. An entity's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the entity; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with [*applicable financial reporting framework, such as accounting principles generally accepted in the United States of America*], and that receipts and expenditures of the entity are being made only in accordance with authorizations of management and those charged with governance; and (3) provide reasonable assurance regarding prevention, or timely detection and correction of unauthorized acquisition, use, or disposition of the entity's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent, or detect and correct misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

[*Opinion paragraph*]

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of W Company as of December 31, 20XX, and the results of its operations and its cash flows for the year then ended in accordance with accounting principles generally accepted in the United States of America. Also in our opinion, W Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 20XX, based on [*identify criteria*].

[*Auditor's signature*]

[*Auditor's city and state*]

[*Date of the auditor's report*]

## 4. Report Date

a. The report should be dated no earlier than the date on which sufficient appropriate evidence has been obtained.

b. The date of the report on internal control should coincide with the date of the audit report on the financial statements.

### 5. Material Weakness in Internal Control

a. The presence of a material weakness in internal control results in an adverse opinion. The auditor's report should include an explanatory paragraph defining the term material weakness, stating that one or more material weaknesses were noted, and referring to the material weakness described in management's assertion.

b. When a material weakness exists, the auditor should express an opinion directly on the effectiveness of internal control, and not on management's assertion:

> In our opinion, because of the effect of the material weakness described above on the achievement of the objectives of the control criteria, W Company has not maintained effective internal control over financial reporting as of December 31, 20XX, based on [*identify criteria*].

c. If management's report fails to include one or more material weaknesses identified by the auditor, the auditor's report should state this, and should describe the omitted weaknesses.

(1) The auditor should communicate this situation, in writing, to those charged with governance.

d. If management's report includes a material weakness but does not fairly present the weakness, the auditor's report should indicate this situation and should fairly describe the material weakness.

e. The auditor should consider the effect of this adverse opinion on the financial statement opinion, and should indicate whether the opinion on the financial statements was affected by the material weaknesses.

## K. Reporting on Internal Control *(issuers)*

1. The auditor is required to report on both the company's financial statements and on its internal control over financial reporting. Two separate reports, or one combined report (that is, one report containing both an opinion on the financial statements and an opinion on internal control), may be issued.

### a. Sample Combined Report

> **Report of Independent Registered Public Accounting Firm**
>
> [*Introductory paragraph*]
>
> We have audited the accompanying balance sheets of W Company as of December 31, 20X8 and 20X7, and the related statements of income, stockholders' equity and comprehensive income, and cash flows for each of the years in the three-year period ended December 31, 20X8. We also have audited W Company's internal control over financial reporting as of December 31, 20X8, based on [*identify control criteria, for example, "criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)"*]. W Company's management is responsible for these financial statements, for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying [*title of management's report*]. Our responsibility is to express an opinion on these financial statements and an opinion on the company's internal control over financial reporting based on our audits.
>
> (continued)

(continued)

[*Scope paragraph*]

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. Our audits of the financial statements included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audits also included performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

[*Definition paragraph*]

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

[*Inherent limitations paragraph*]

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

[*Opinion paragraph*]

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of W Company as of December 31, 20X8 and 20X7, and the results of its operations and its cash flows for each of the years in the three-year period ended December 31, 20X8, in conformity with accounting principles generally accepted in the United States of America. Also in our opinion, W Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 20X8, based on [*identify control criteria, for example, "criteria established in Internal Control – Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)"*].

[*Signature*]

[*City and State or Country*]

[*Date*]

b. If separate reports are issued, each report should contain an explanatory paragraph making reference to the other report and indicating the nature of the opinion expressed:

> [*Add to the report on the financial statements.*]
>
> We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), W Company's internal control over financial reporting as of December 31, 20X8, based on [*identify control criteria*] and our report dated [*date of report, which should be the same as the date of the report on the financial statements*] expressed [*include nature of opinion*].

> [*Add to the report on internal control.*]
>
> We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the [*identify financial statements*] of W Company and our report dated [*date of report, which should be the same as the date of the report on the effectiveness of internal control over financial reporting*] expressed [*include nature of opinion*].

## 2. Report Date

a. The report should be dated no earlier than the date on which sufficient appropriate evidence has been obtained.

b. The date of the report on internal control should coincide with the date of the audit report on the financial statements.

## 3. Material Weakness in Internal Control

a. A material weakness requires the auditor to issue an adverse opinion.

b. The auditor's report must include the definition of a material weakness, a statement that a material weakness has been identified, and an identification of the material weakness described in management's assessment.

c. If management's report fails to include one or more material weaknesses identified by the auditor, the auditor's report should state this, and should describe the omitted weaknesses.

(1) The auditor should communicate this situation, in writing, to those charged with governance.

d. If management's report includes a material weakness but does not fairly present the weakness, the auditor's report should indicate this situation and should fairly describe the material weakness.

e. The auditor should consider the effect of this adverse opinion on the financial statement opinion, and should indicate whether the opinion on the financial statements was affected by the material weaknesses.

## 4. Reporting on whether a Previously Reported Internal Control Weakness Continues to Exist

In some cases, management's assessment of the company's internal control over financial reporting may reveal that the company has one or more material weaknesses.

If the material weaknesses are subsequently eliminated, management may wish to communicate this fact to the investing public, and may also wish to have an independent auditor attest to the improvements in internal control.

a. An engagement to report on whether a previously reported internal control weakness continues to exist is a voluntary engagement, not required by professional standards. The engagement may be performed at any time during the year.

b. The auditor's objective is to express an opinion on whether a previously reported material weakness has been eliminated.

c. The auditor may perform such an engagement only if:

(1) He or she has sufficient overall knowledge of both the company and its internal control over financial reporting.

(2) Management accepts responsibility for the effectiveness of internal control, evaluates its effectiveness, asserts that internal control is effective, provides support for this assertion, and presents a written report that will accompany the auditor's report.

d. The auditor's testing is limited to the controls specifically identified by management as eliminating the material weakness.

e. To issue an unmodified opinion, the auditor must obtain evidence about the design and operating effectiveness of the specifically identified controls, determine that the material weakness has been eliminated, and determine that no scope limitations were placed on his or her work.

## L. Other Reporting Issues *(issuers and nonissuers)*

### 1. Scope Limitations

The auditor should withdraw from the engagement or issue a disclaimer of opinion if the scope of the audit is restricted.

a. When disclaiming an opinion because of a scope limitation, the auditor should state that an opinion is not being expressed, and in a separate paragraph or paragraphs, the substantive reasons for the disclaimer. In a disclaimer of opinion, the auditor should:

(1) Modify the first sentence of the introductory paragraph slightly ("We were engaged to examine…") and omit the last sentence.

(2) Omit the scope paragraph.

(3) Include an explanatory paragraph describing the reason for the disclaimer.

(4) Revise the opinion paragraph:

> Because of the limitation on the scope of our audit described in the second paragraph, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion on the effectiveness of W Company's internal control over financial reporting.

b. Language that might overshadow the disclaimer (e.g., a list of procedures performed or commonly performed in an examination) should not be used.

c. Any material weaknesses identified should be described, and the definition of a material weakness should be included, in the disclaimer.

d. If the auditor cannot express an opinion due to a scope limitation, management and those charged with governance should be informed, in writing.

e. The auditor may issue a report disclaiming an opinion on internal controls as soon as the auditor concludes that a scope limitation will prevent the auditor from obtaining the assurance necessary to express an opinion.

**2. Another Auditor**

Private company - OK
Public company - no

As is the case with a financial statement audit, *another auditor* may be involved in the audit of an entity's internal control. The principal auditor decides whether the involvement of the other auditor warrants reference in the auditor's report.

a. The decision about whether to make reference to another auditor in the report on internal control is independent of the similar decision made with respect to the financial statement audit. The two decisions may differ.

**3. Subsequent Events**

As is the case with a financial statement audit, *subsequent events* (in this case, changes in internal control) may occur after the "as of" date of the report, but prior to the date of the auditor's report.

a. The auditor should:

(1) Inquire of management.

(2) Obtain written representations from management.

(3) Inquire about and examine documentation for the subsequent period.

b. If, before the date of the auditor's report, the auditor obtains information about a matter that existed on the "as of" date of the report, appropriate action should be taken (for example, an adverse opinion would be issued if a material weakness were discovered).

c. If the auditor obtains information about conditions that arose subsequent to the "as of" date of the auditor's report, this information should be included in an explanatory paragraph of the report.

d. The auditor has no responsibility to keep informed with respect to events occurring after the date of the report, but if the auditor becomes aware of conditions that existed at the report date, appropriate action should be taken.

More limited Extra

## M. Financial Statement Audit vs. Examination of Internal Control *(nonissuers)*

### 1. Differences Between the Two Engagements

#### a. Purpose

The purpose of an examination of the effectiveness of an entity's internal control is to express an opinion about whether the entity maintained, in all material respects, effective internal control as of a point in time based on the control criteria. The purpose of an auditor's consideration of internal control in an audit of financial statements conducted in accordance with GAAS is to enable the auditor to plan the audit and determine the nature, extent, and timing of tests to be performed.

#### b. Relevant Period

An examination of internal control results in an opinion on internal control as of a point in time, while an opinion on financial statements relates to a longer period of time, such as a year.

#### c. Extent of Testing

An auditor's consideration of internal control in a financial statement audit is more limited than that of an auditor engaged to examine the effectiveness of the entity's internal control. In order to render an opinion on internal control, the auditor should obtain evidence about the effectiveness of selected controls over *all* relevant assertions. In a financial statement audit, the auditor is not required to test controls over *all* relevant assertions (for example, if a substantive approach is to be used instead).

#### d. Communication of Control Deficiencies

(1) In a financial statement audit, the communication of significant deficiencies and material weaknesses must be made within 60 days of the report release date, whereas in an audit of internal control, the communication must be made by the report release date.

(2) In a financial statement audit, the communication of significant deficiencies and material weaknesses should include restricted use language, but in an audit of internal control, no restriction on the use of the report is required.

**2. Interrelationships Between the Two Engagements**

The results from one type of engagement should be considered in performing the other type of engagement.

a. In forming an opinion on internal control, the auditor should consider the results of tests of controls performed as part of the financial statement audit.

b. In concluding on the effectiveness of controls as part of the financial statement audit, the auditor should consider the results of tests performed as part of the internal control audit.

c. If, during the examination of internal control, a deficiency is noted, the auditor should consider this deficiency in determining the nature, timing, and extent of substantive tests in the financial statement audit.

d. The auditor should consider whether any observations made during the financial statement audit impact the auditor's opinion on internal control. For example, identified misstatements might imply that controls are not functioning effectively.

(1) Note that the absence of misstatements does not imply operating effectiveness, although it may affect the auditor's assessment of risk.

## N. Foreign Corrupt Practices Act *(FCPA)*

The FCPA includes provisions regarding internal accounting control for certain entities. Compliance with the FCPA is a legal determination. An examination of the effectiveness of internal control under Statements on Standards for Attestation Engagements generally would not be sufficient to determine whether an entity is in compliance with this Act.

We're not lawyers

# COMMUNICATION WITH THOSE CHARGED WITH GOVERNANCE

## I. THOSE CHARGED WITH GOVERNANCE

As covered previously, the term "those charged with governance" refers to those who bear responsibility to oversee the obligations and strategic direction of an entity, including the financial reporting process. This term is broadly interpreted to encompass the terms "board of directors" and "audit committee."

### A. Governance Structure

Those charged with governance may include:

1. Members of the entity's legal structure, such as company directors.
2. Parties external to the entity, such as certain government agencies.
3. A collective group of people such as a board of directors, or a single person, such as an owner-manager.
4. Personnel that also have management responsibilities.

### B. Audit Committees

#### 1. What is an Audit Committee?

An *audit committee* is a committee of the board of directors, generally made up of three to five members of the board who are "outside directors." Outside directors are individuals who are neither employees nor part of management and who do not have a material financial interest in the company. An audit committee is generally a subgroup of those charged with governance.

#### 2. Purpose of an Audit Committee

Many companies have established audit committees because:

a. The SEC has strongly recommended this action, and the New York Stock Exchange requires all companies listed on the exchange to have audit committees.

b. Many large accounting firms and leading accountants in the country have strongly supported the formation of audit committees.

c. The use of audit committees tends to strengthen the public's sense of the independence of the public accountant.

#### 3. Specific Functions of Audit Committees

The main function of an audit committee is to enhance internal control by creating a means of direct communication between the "outside directors" and the independent auditor. An audit committee is considered to be part of the internal control structure. The audit committee typically:

a. Selects and appoints the independent auditor and sets the audit fee.

b. Assures that the auditor is independent of the company.

c. Reviews the nature and details of the audit engagement.

d. Reviews the quality of the auditor's work.

e. Reviews the scope of the audit.

f. Ensures that any recommendations made by the auditor are given proper attention.

g. Maintains lines of communication between the auditor and the board of directors.

h. Helps solve any disagreements related to the accounting treatment of any material items in the financial statements.

i. Evaluates the internal control of the company with the help of the independent auditor.

j. Makes reports to the board of directors and the stockholders when necessary.

**4. Communication with the Audit Committee**

*Communication with the audit committee* is a key element in the auditor's communication with those charged with governance. The auditor should:

a. Have appropriate access to the audit committee periodically.

b. Meet with the audit committee without management present at least once each year.

c. Consider whether communication with the audit committee is sufficient or whether there is also a need to communicate with others charged with governance.

**5. Sarbanes-Oxley Requirements**

The *Sarbanes-Oxley Act*, applying to issuers, requires the audit committee to approve the engagement of the auditor, to preapprove the services to be performed, and to have ongoing communications with the auditor. In effect, auditors of issuers report to and are overseen by the audit committee, not by management.

## II. REQUIRED COMMUNICATIONS

An auditor conducting an audit of financial statements has a responsibility to communicate certain matters to those charged with governance.

### A. Matters Related to the Auditor's Responsibility

1. An auditor is required to communicate to those charged with governance the auditor's responsibilities with regard to a financial statement audit, including that:

a. The auditor is responsible for forming and expressing an opinion about whether the financial statements are prepared, in all material respects, in conformity with the applicable financial reporting framework.

b. The audit does not relieve management or those charged with governance of their responsibilities.

c. The auditor is responsible for performing the audit in accordance with GAAS.

d. The audit is designed to provide reasonable, rather than absolute, assurance about whether the financial statements are free from material misstatement.

e. The audit of financial statements includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control over financial reporting (nonissuers only).

f. The auditor is responsible for communicating significant matters related to the financial statement audit.

g. When applicable, the auditor is responsible for communicating particular matters required by law or regulation, by agreement with the entity, or by additional requirements applicable to the engagement.

h. In certain situations, the auditor may determine that it is appropriate to communicate circumstances or relationships that, in the auditor's professional judgment, may reasonably be thought to bear on independence, and to which the auditor gave significant consideration, in reaching the conclusion that independence has not been impaired.

These responsibilities may be communicated through the engagement letter (required for issuers), or other form of contract that records the terms of the engagement, if the letter or contract is given to those charged with governance.

## B. Overview of the Planned Scope and Timing of the Audit

The auditor should communicate with those charged with governance regarding the planned scope and timing of the audit.

1. The purpose of communicating this information is to provide insight to those charged with governance regarding the auditor's activities, as well as to improve the auditor's understanding of the entity.
2. The auditor may communicate how significant risks of material misstatement will be addressed, the planned approach toward internal control, factors affecting materiality, and any potential use of internal audit staff.
3. The auditor should be careful not to compromise the effectiveness of audit procedures, for example by making them too predictable.
4. The auditor may also solicit information from those charged with governance. For example, the auditor may inquire as to the party with whom the auditor should communicate, the allocation of responsibility between management and those charged with governance, the entity's objectives, strategies, and risks, matters to which the auditor should pay particular attention, and significant communications with regulators.
5. The communication may also include discussion of the attitudes, awareness, and actions of those charged with governance with respect to internal control, fraud, relevant changes (e.g., changes to financial reporting, accounting standards, laws, etc.), and matters previously communicated by the auditor.

## C. Significant Audit Findings

1. The auditor should communicate:

   a. The auditor's views about qualitative aspects of the entity's accounting practices, including:

      (1) the initial selection of, changes in, and appropriateness of significant accounting policies;

      (2) the process used by management in formulating significant accounting estimates and the basis for the auditor's conclusions regarding the reasonableness of the estimates;

      (3) significant management judgments; and

      (4) the adequacy of financial statement disclosures.

   b. Significant difficulties encountered in performing the audit (e.g., delays, unreasonable timetables, lack of cooperation).

   c. Disagreements with management, whether or not resolved.

   d. Uncorrected, nontrivial misstatements and their possible effect on the audit opinion, including the effect of uncorrected misstatements related to prior periods.

(1) Material uncorrected misstatements should be identified individually.

(2) The auditor should request the correction of uncorrected material misstatements.

(3) The auditor may also communicate uncorrected immaterial misstatements, such as frequently occurring misstatements that may indicate bias in the preparation of financial statements.

e. Any circumstances that may appear to impair independence (although presumably the auditor has concluded that independence has not been impaired).

f. Evaluation of the company's identification of, accounting for, and disclosure of its relationships and transactions with related parties.

g. Other issues that the auditor judges to be significant.

2. If all of those charged with governance are not involved with managing the entity, the auditor should also communicate:

a. Significant issues or findings arising from the audit that were discussed with management.

b. Material, corrected misstatements brought to management's attention as a result of the audit. (The auditor may also choose to communicate corrected misstatements that are immaterial but frequently recurring.)

c. Management representations requested by the auditor.

d. Management's consultation with other accountants.

## D. Two-way Communication

1. Communication should be two-way. Those charged with governance should also communicate relevant matters to the auditor.

2. The auditor should communicate the purpose, form, timing, and expected general content of further communications, as a means of establishing effective two-way communication.

3. The auditor may request additional information from those charged with governance as a means of obtaining further audit evidence.

4. There should be an established process for each party to take action and report back to the other.

5. Inadequate two-way communication may be indicative of an unsatisfactory control environment, which may affect the auditor's assessment of the risk of material misstatement.

## E. Communication with Management

1. Generally, the auditor may discuss matters with management prior to communicating those matters to those charged with governance.

2. Certain matters communicated to those charged with governance, such as those related to the competence and integrity of management, might not be appropriate for discussion with management.

**F. Other Standards**

**1. Other Auditing Standards**

Other auditing standards may also require communication with those charged with governance. For example, communication may be required with respect to internal control related matters, fraud, illegal acts, compliance-related matters in government audits, going concern issues, and matters related to a review of interim financial information.

**2. Sarbanes-Oxley Requirements**

As a result of the Sarbanes-Oxley Act, auditors of issuers are required to report (to the audit committee) all critical accounting policies, all material alternative GAAP accounting treatments, and other material communications between the auditor and management (e.g., management letters, schedules of unadjusted differences, etc.). If no formal audit committee exists, communications should be made to the full board of directors.

## III. FORM AND TIMING OF COMMUNICATION

### A. Form of Communication

In general, communications may be oral or in writing.

1. Significant audit findings should be communicated in writing when, in the auditor's judgment, oral communication would be inadequate.
    a. Matters communicated during the audit that were appropriately resolved need not be included in the written communication.
2. The auditor may also choose to communicate other matters in writing based on the specific circumstances involved.
3. Written communications should include a limitation on the use of the communication indicating for whom it is intended, and warning that it should not be used by others.

| U.S. AUDITING STANDARDS VS. INTERNATIONAL STANDARDS ON AUDITING |
| --- |
| ISAs do not require or prohibit that the written communication to those charged with governance include a limitation on the use of the communication. |

4. Oral communications should be documented; copies of written communications should be retained.

### B. Timing of Communication

1. Timing of the communications may vary according to circumstance, but should occur on a timely basis in a manner that allows appropriate action to be taken.
2. For audits of issuers, communications are required to be made before issuance of the auditor's report.

**PCAOB STANDARDS—GUIDANCE FOR ISSUERS**

In addition to the items already covered, the PCAOB's audit committee communication requirements for issuers include the following:

- Additional information related to the planned scope and timing of the audit, including:
  - The nature and extent of specialized skill or knowledge needed to complete the engagement.
  - The extent to which the auditor will use the work of the company's internal auditors when performing the financial statement audit.
  - The extent to which the auditor will use the work of internal auditors, company personnel, and third parties when performing the internal control audit.
  - The names, locations, and responsibilities of other public accounting firms that will perform audit procedures.
  - The basis for the determination that the auditor is the principal auditor, if other auditors will perform significant work in the engagement.
- Additional matters related to significant audit findings, including:
  - The effect on the financial statements or disclosures of significant accounting policies in controversial areas or areas where there is a lack of authoritative guidance.
  - Critical accounting policies and practices (defined as the company's accounting policies and practices that are most important to the portrayal of financial position and require significant management judgment, including the need to make estimates).
  - Critical accounting estimates.
  - Significant unusual transactions.
  - Situations where the auditor identified bias in management's judgments.
  - The auditor's views on matters about which management consulted with other accountants.
- Matters related to going concern, when there is substantial doubt about the company's ability to continue as a going concern, including:
  - The conditions and events that the auditor identified that indicate that there is substantial doubt.
  - The effect of the substantial doubt on the financial statements and adequacy of disclosure.
  - The effect of the substantial doubt on the auditor's report.
  - If the auditor concludes that substantial doubt about the company's ability to continue as a going concern is alleviated by management's plans, the basis for this conclusion.
- The reasons for modification of the auditor's opinion.
- The reasons for and wording of explanatory language added to the auditor's report.

# MANAGEMENT REPRESENTATIONS

Management Representation

## I. REPRESENTATION LETTER—OVERVIEW

At the conclusion of fieldwork, the independent auditor must obtain a management representation letter from the client. The auditor prepares the text of the representation letter, which is then printed on client letterhead and signed by the client.

Failure to obtain a rep. letter = Scope limitation

### A. Purposes of Representation Letter

The three primary purposes for obtaining written representations from management are:

1. To confirm representations explicitly or implicitly given to the auditor.
2. To indicate and document the continuing appropriateness of such representations.
3. To reduce the possibility of misunderstanding concerning matters that are the subject of the representations.

### B. Requirements

In the management representation letter, the client asserts that all material matters have been adequately disclosed to the independent auditor.

**1. Final Piece of Evidential Matter**

The representation letter is obtained at the end of the auditor's fieldwork and covers the period up to the date of the auditor's report. It should address all financial statements and periods covered by the report, even if current management was not present during all such periods.

**2. Letter is Mandatory**

The auditor must receive the letter in order to render an unmodified opinion. Management's refusal to furnish a written representation letter generally results in a disclaimer of opinion or in withdrawal from the engagement.

**3. Dated Same Date as Audit Report**

The client representation letter should be dated as of the date of the auditor's report.

| U.S. AUDITING STANDARDS VS. INTERNATIONAL STANDARDS ON AUDITING |
| --- |
| ISAs require the date of the written representations be as near as possible to, but not after, the date of the auditor's report. U.S. auditing standards require that the date of the written representations be the date of the auditor's report. |

a. Occasionally, circumstances may prevent management from signing the representation letter and returning it to the auditor on the date of the auditor's report. When this happens, the auditor may accept management's oral confirmation, on or before the date of the auditor's report, that management has reviewed the final representation letter and will sign the representation letter without exception as of the date of the auditor's report.

b. Possession of the signed representation letter is necessary before releasing the auditor's report.

4. **Signed by CEO and CFO**

   The members of management with overall responsibility for financial and operating matters who are responsible for and knowledgeable about the items contained in the letter (usually the CEO and CFO) should sign the letter. Other officers and employees may also be asked to sign the letter.

5. **Representations**

   In the representation letter, management provides information on the financial statements, the completeness of information, recognition, measurement, and disclosure, and subsequent events.

6. **Materiality**

   Representations may be limited to items that management and the auditor agree are material. Materiality considerations do not apply to items not directly related to financial statement amounts (e.g., all minutes and all financial records should be made available to the auditor).

7. **Doubt About the Reliability of Written Representations**

   If the auditor concludes that written representations are not reliable due to concerns about the competence, integrity, ethical values, or diligence of management, or because of unresolved inconsistencies between the written representations and other audit evidence, the auditor should consider the possible effect on the audit opinion. When the auditor concludes that there is sufficient doubt about the integrity of management, the auditor should disclaim an opinion or withdraw from the engagement.

## II. CONTENTS OF MANAGEMENT REPRESENTATION LETTER

### A. Financial Statements

Management is responsible for:

1. the fair presentation of the financial statements in accordance with the applicable financial reporting framework; and
2. for the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

### B. Completeness of Information

1. Management has provided the auditor with all relevant information and access, as agreed upon in the terms of the engagement.
2. All transactions have been recorded and are reflected in the financial statements.

### C. Fraud

1. Acknowledgment of management's responsibility for the design, implementation, and maintenance of internal control to prevent and detect fraud.
2. Management has disclosed to the auditor the results of its assessment of the risk that the financial statements may be materially misstated as a result of fraud.
3. Management has disclosed to the auditor its knowledge of fraud or suspected fraud affecting the entity involving:
   a. management;
   b. employees who have significant roles in internal control; or

c. others, when the fraud could have a material effect on the financial statements.

4. Management has disclosed to the auditor its knowledge of any allegations of fraud or suspected fraud affecting the entity's financial statements communicated by employees, former employees, analysts, regulators, or others.

**D. Laws and Regulations**

All instances of identified or suspected noncompliance with laws and regulations whose effects should be considered by management when preparing financial statements have been disclosed to the auditor.

**E. Uncorrected Misstatements**

Management believes the effects of uncorrected misstatements are immaterial, individually or in the aggregate, to the financial statements as a whole. A summary of these items should be included in or attached to the written representation.

**F. Litigation and Claims**

All known actual or possible litigation and claims whose effects should be considered by management when preparing the financial statements have been disclosed to the auditor and accounted for and disclosed in accordance with the applicable financial reporting framework.

**G. Estimates**

Whether management believes significant assumptions used when making accounting estimates are reasonable.

**H. Related Party Transactions**

1. Disclosure of the identity of the entity's related parties and all related party relationships and transactions of which it is aware.

2. Management has appropriately accounted for and disclosed such relationships and transactions.

**I. Subsequent Events**

All events occurring subsequent to the date of the financial statements and for which the applicable financial reporting framework requires adjustment or disclosure have been adjusted or disclosed.

**J. Additional Representations**

The auditor should obtain additional representations from management regarding issues specific to the entity's financial statements. Possible topics include the impact of a new accounting principle, impairment of assets, intent to hold debt securities to maturity, obsolescence of inventory, restrictions on cash, plans to discontinue a line of business, etc.

## K. Sample Representation Letter

* For HW

(Entity Letterhead)

To [*Auditor*] [*Date*]

This letter is provided in connection with your audit of the financial statements of ABC Company, which comprise the balance sheet as of December 31, 20XX, and the related statements of income, changes in stockholders' equity, and cash flows for the year then ended, and the related notes to the financial statements, for the purpose of expressing an opinion on whether the financial statements are presented fairly, in all material respects, in accordance with accounting principles generally accepted in the United States (U.S. GAAP).

Certain representations in this letter are described as being limited to matters that are material. Items are considered material, regardless of size, if they involve an omission or misstatement of accounting information that, in the light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would be changed or influenced by the omission or misstatement.

Except where otherwise stated below, immaterial matters less than $[*insert amount*] collectively are not considered to be exceptions that require disclosure for the purpose of the following representations. This amount is not necessarily indicative of amounts that would require adjustment to or disclosure in the financial statements.

We confirm that, [*to the best of our knowledge and belief, having made such inquiries as we considered necessary for the purpose of appropriately informing ourselves*] [*as of (date of auditor's report)*]:

*Financial Statements*

1. We have fulfilled our responsibilities, as set out in the terms of the audit engagement dated [*insert date*], for the preparation and fair presentation of the financial statements in accordance with U.S. GAAP.
2. We acknowledge our responsibility for the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.
3. We acknowledge our responsibility for the design, implementation, and maintenance of internal control to prevent and detect fraud.
4. Significant assumptions used by us in making accounting estimates, including those measured at fair value, are reasonable.
5. Related party relationships and transactions have been appropriately accounted for and disclosed in accordance with the requirements of U.S. GAAP.
6. All events subsequent to the date of the financial statements and for which U.S. GAAP requires adjustment or disclosure have been adjusted or disclosed.
7. The effects of uncorrected misstatements are immaterial, both individually and in the aggregate, to the financial statements as a whole. A list of the uncorrected misstatements is attached to the representation letter.
8. The effects of all known or possible litigation and claims have been accounted for and disclosed in accordance with U.S. GAAP.

*[Any other matters that the auditor may consider appropriate.]*

*Information Provided*

9. We have provided you with:
    a. Access to all information, of which we are aware that is relevant to the preparation and fair presentation of the financial statements such as records, documentation and other matters;
    b. Additional information that you have requested from us for the purpose of the audit; and
    c. Unrestricted access to persons within the entity from whom you determined it necessary to obtain audit evidence.

(continued)

(continued)

10. All transactions have been recorded in the accounting records and are reflected in the financial statements.
11. We have disclosed to you the results of our assessment of the risk that the financial statements may be materially misstated as a result of fraud.
12. We have [*no knowledge of any*] [*disclosed to you all information that we are aware of regarding*] fraud or suspected fraud affecting the entity and involves:
    a. Management,
    b. Employees who have significant roles in internal control, or
    c. Others where the fraud could have a material effect on the financial statements.
13. We have [*no knowledge of any*] [*disclosed to you all information that we are aware of regarding*] allegations of fraud, or suspected fraud, affecting the entity's financial statements communicated by employees, former employees, analysts, regulators, or others.
14. We disclosed to you all known instances of non-compliance or suspected non-compliance with laws and regulations whose effects should be considered when preparing financial statements.
15. We [*have disclosed to you all known actual or possible*][*are not aware of any pending or threatened*] litigation and claims whose effects should be considered when preparing financial statements [*and we have not consulted legal counsel concerning litigation or claims*].
16. We have disclosed to you the identity of the entity's related parties and all the related party relationships and transactions of which we are aware.

[*Any other matters that the auditor may consider necessary.*]

____________________________________

[*Name of Chief Executive Officer and Title*]

____________________________________

[*Name of Chief Financial Officer and Title*]

**PASS KEY**

Remember that the management representation letter is required. Management's refusal to furnish written representations will generally result in either a disclaimer of opinion or in withdrawal from the engagement.

# AUDITING 6

*Professional Responsibilities, Audit Documentation, Effect of IT, Government Auditing, and Quality Control Standards*

## NOTES

# PROFESSIONAL RESPONSIBILITIES

State board can revoke or suspend your CPA license

## I. AICPA CODE OF PROFESSIONAL CONDUCT

Code of Professional Conduct

The AICPA's Code of Professional Conduct governs any service that a member of the AICPA performs. These services include audits, special reports, compilations, reviews, and services performed on financial forecasts and projections, as well as attestation engagements. Members not in public practice are governed by certain requirements of the Code of Professional Conduct as well.

### A. Introduction

1. The AICPA Code of Professional Conduct addresses the question of what is "right" and "just." The code is applicable to all members of the AICPA, not just to those in public practice.
2. A professional code of conduct is a *distinguishing mark of a profession* that accepts a high degree of responsibility toward the public. It is a voluntary acceptance for the purpose of benefiting society.
3. The code utilizes certain terms to enhance the clarity of the interpretations and definitions.
   a. *Consider*—Used when the member is required to think about several matters.
   b. *Evaluate*—Used when the member has to assess and weigh the significance of a matter.
   c. *Determine*—Used when the member has to come to a conclusion and make a decision on a matter.
4. The code consists of principles and rules as well as *interpretations* and other guidance.

### B. Principles

Principles

Principles provide the framework that is the basis for the code of conduct.

**1. Responsibilities**

"In carrying out their responsibilities as professionals, members should exercise sensitive professional and moral judgments in all their activities."

**2. Public Interest**

"Members should accept the obligation to act in a way that will serve the public interest, honor the public trust, and demonstrate commitment to professionalism." This relates to the profession's acceptance of responsibility to the public.

**3. Integrity**

"To maintain and broaden public confidence, members should perform all professional responsibilities with the highest sense of integrity." Integrity addresses the question of what is right and just.

**4. Objectivity and Independence**

"A member should maintain objectivity and be free of conflicts of interest in discharging professional responsibilities. A member in public practice should be *independent in fact and appearance* when providing auditing and other attestation services." (Emphasis added.)

Corp. employee (CPA)

**PASS KEY**

For exam purposes, it is key to remember that objectivity applies to all services rendered; but independence applies to attestation services only (audits, special reports, and reviews).

Examine financial forecast

5. **Due Care** = No negligence

"A member should observe the profession's technical and ethical standards, strive continually to improve competence and the quality of services, and discharge professional responsibility to the best of the member's ability."

6. **Scope and Nature of Services**

"A member in public practice should observe the Principles of the Code of Professional Conduct in determining the scope and nature of services to be provided."

This requires members to:

a. Have adequate internal quality control measures to ensure quality work;

b. Determine whether, for audit clients, conflicts of interest arise due to the scope and nature of other services; and

c. Assess whether the firm's activities are consistent with professionalism.

## C. Rules

Rules

The "rules" portion of the code consists of rules, interpretations, and rulings that govern the specific performance of members. The rules that apply to members are based on whether they are a member in public practice, a member in business, and/or an other member.

**RULES BY TYPE OF MEMBER**

| *Rules* | *Member* | | |
|---|---|---|---|
| | *Member in Public Practice* | *Member in Business* | *Other Member (i.e., retired or unemployed)* |
| Independence Rule | x | | |
| Integrity and Objectivity Rule | x | x | |
| General Standards Rule | x | x | |
| Compliance with Standards Rule | x | x | |
| Accounting Principles Rule | x | x | |
| Confidential Client Information Rule | x | | |
| Contingent Fees Rule | x | | |
| Acts Discreditable Rule | x | x | x |
| Advertising and Other Forms of Solicitation Rule | x | | |
| Commissions and Referral Fees Rule | x | | |
| Form of Organization and Name Rule | x | | |

1. **Independence Rule**

Independence

a. A member in public practice shall be independent in the performance of professional services as required by standards promulgated by bodies designated by the AICPA Council.

Must disclose in report

(1) Independence is *not required* for compilations and non-attestation services (e.g., tax services, consulting services).

(2) Independence must be maintained by "covered members": all partners in the office connected with the attest engagement, partners or managers who provide non-attest services to the attest client, all members of the attest engagement team, the firm itself, and any parties who can influence the attest engagement.

GR:
- Covered member - audit team and boss/office "chain of command"
- Immediate family - spouse and dependents
- Close relatives - parents, siblings and adult kids



(3) A covered member's spouse and dependents are also generally subject to the Independence Rule.

(4) A member must have independence of mind and in appearance.

**b. Independence Impaired by Financial Interests**

(1) Independence is impaired if a covered member has a direct financial interest (regardless of materiality) or a material indirect financial interest in an attestation client.

| EXAMPLE |
|---|
| Direct financial interests are ownership interests held directly in a client. Examples would include:<br>• Stock ownership, even if owned in a blind trust.<br>• Financial interest in a client through a partnership and the member is a general partner.<br>• Financial interest in a trust when the member is the trustee.<br>An indirect financial interest involves a removed relationship. Examples would include:<br>• Member owns shares in a mutual fund that invests in the attestation client.<br>• Member owns a direct financial interest in Company A and Company A has a direct financial interest in the attestation client. |

(2) Independence will be impaired if a covered member or his immediate family (spouse or dependents) has a loan to or from a client.

(3) Independence is impaired by acceptance of more than a token gift.

(4) Independence is *not impaired* in a financial institution client by:

Bank

OK
Ordinary course of business

(a) Fully collateralized car loans with a financial institution client.

(b) Cash advance or credit card balances not exceeding $10,000.

(c) A bank account that is fully insured by the government.

(d) A passbook loan.

(5) Independence is impaired if a close relative has a financial interest in the attest client that the covered member knows or has reason to believe is material to the close relative or enabled the close relative to exercise significant influence over the attest client.

**c. Independence Impaired by Employment Relationships** Attestation

Independence may be impaired if a member was previously employed by the attest client, or if a member leaves the audit firm for a position with the client.

Client officer → Joins CPA firm

(1) Independence is impaired if an individual who was formerly employed by the client participates on the engagement team or is in a position to influence the engagement when the engagement covers any period of his or her former employment with the client.

Spouse → Works for client

(2) Independence is impaired by an immediate family member or close relative's employment with a client in a *key position* (e.g., independence would be impaired if the spouse was the client's internal auditor).

Employee CPA firm → Hired by client as exec.

(3) Independence is impaired if a partner or professional employee leaves the firm and is employed by the client in a key position unless the individual is no longer in a position to influence or participate in the firm's business decisions and the amounts due to the individual are immaterial to the firm.

(a) When the individual joins the client in a key position within one year of disassociating from the firm and has significant interaction with the engagement team, independence will be impaired unless the engagement is reviewed by a qualified professional to determine whether the engagement team members maintained the appropriate level of skepticism when evaluating the representations and work of the former firm member.

CPA interested in job at client's company

(4) Independence is impaired if an individual who is a member of the engagement team or is in a position to influence the engagement is seeking or discussing potential employment with the client or has been offered employment by the client, unless the individual notifies the firm and is removed from the engagement.

### d. Independence Impaired by Business Relationships

Independence is impaired if a member makes management decisions for an attest client.

| EXAMPLE |
|---|
| Examples of business relationships with an attestation client that impair independence would include:<br>• Director, officer, employee, or a position where the member acts in a management capacity.<br>• Promoter, underwriter, broker-dealer, voting trustee.<br>• Stock transfer or escrow agent.<br>• General counsel.<br>• Trustee for a client's pension or profit-sharing trust. |

**Non-attest Services**

(1) A firm may perform non-attest services for a client and still be independent as long as the firm does not serve or appear to serve as a member of a client's management (e.g., the firm may not make operational or financial decisions for the client, perform management functions, or report to the board on behalf of management).

| EXAMPLE |
|---|
| Examples of activities with an attestation client that impair independence would include:<br>• Bookkeeping activities that include authorizing, executing or consummating a transaction on behalf of a client or preparing source documents or originating data (e.g., purchase orders).<br>• Having custody of the clients' assets.<br>• Supervising client employees in the performance of normal recurring activities.<br>• Financial information systems design and implementation.<br>• Appraisal, valuation, or actuarial services when the results are material to the financial statements and subject to a significant degree of subjectivity.<br>• Management of internal audit activities.<br>• Litigation services where the firm serves as a trier of fact, special master, court-appointed expert, or arbitrator.<br>• Expert witness services. |

(2) Independence is not impaired by being a member of or an honorary trustee for a not-for-profit charitable, civic or religious group if the position is purely honorary and the member does not participate in any management functions. OK

(3) Membership in the same trade association as a client does not impair independence unless the member serves in a management capacity. Country club OK

A/R over 1 year = Bad

e. A member's independence is impaired with respect to a client who is more than one year overdue in the payment of professional fees. Usually, fees from one year must be paid before the issuance of a report on the following year's work.

f. Actual or threatened litigation may impair independence, regardless of who is the plaintiff and who is the defendant.

(1) For example, independence is impaired if an auditor sues management for fraud or if the client sues the auditor for audit deficiencies. Even the threat of a suit for audit deficiencies would impair independence if it is likely the suit will be initiated.

(2) Independence is *not impaired* by a suit for an immaterial dollar amount for work unrelated to an attestation service.

| PASS KEY |
|---|
| The most heavily tested area of the Code of Conduct and professional responsibilities is the Independence Rule. Candidates should be very familiar with the rules covered above. |

**2. Integrity and Objectivity Rule** CPA/CPA firm/Company employees

"In the performance of any professional service, a member shall maintain objectivity and integrity, shall be free of conflicts of interest, and shall not knowingly misrepresent facts or subordinate his or her judgment to others."

a. A conflict of interest may occur if a member has a significant relationship with a client that could be viewed as impairing the member's objectivity.

(1) The service may still be performed if the relationship is disclosed and the consent of the client is obtained.

(2) Disclosure and consent cannot eliminate the necessity for independence when it is required.

b. Members engaged in educational services and client advocacy must act with integrity and objectivity.

**3. General Standards Rule**

A member must comply with the following standards in all engagements:

**a. Professional Competence**

Professional Competence

Undertake only those professional services that the member or the member's firm can reasonably be expected to complete with professional competence.

(1) Professional competence includes the technical qualifications of the CPA and of the CPA's staff, the ability to supervise and evaluate work, and the knowledge of technical subject matter or the ability to obtain that knowledge by research or by consulting with others.

Due Professional Care

b. **Due Professional Care**

Exercise due professional care in the performance of professional services.

(1) The member must possess the same degree of skill commonly possessed by others in the field.

(2) The member must act as a reasonably prudent accountant would.

(3) The member must critically review work done by those assisting in the engagement at every level of supervision.

c. **Planning and Supervision**

Adequately plan and supervise the performance of professional services.

d. **Sufficient Relevant Data** "Not all"

Obtain sufficient relevant data to afford a reasonable basis for conclusions or recommendations in relation to any professional services performed.

4. **Compliance With Standards Rule** = Measure the quality of performance

A member who performs auditing, review, compilation, management consulting, tax, or other professional services must comply with standards promulgated by bodies designated by the AICPA Council.

a. Auditing Standards Board and PCAOB (issue statements on auditing standards).

b. Management Consulting Services Executive Committee (issues statements on standards for management consulting services).

c. Accounting and Review Services Committee (issues statements on standards for accounting and review services).

d. Government Accounting Standards Board (issues statements of governmental accounting standards).

e. Tax Executive Committee (issues statements on tax services).

f. Attestation Standards (issue statements for attestation standards).

g. Financial Accounting Standards Board (establishes standards for U.S. financial accounting and reporting).

h. International Accounting Standards Board (establishes standards for international financial accounting and reporting).

i. Personal Financial Planning Executive Committee (issue standards on personal financial planning).

5. **Accounting Principles Rule** GR: GAAP should be followed

a. A member shall not express an opinion or state affirmatively or negatively that financial statements are presented in conformity with generally accepted accounting principles (GAAP) if there is any departure from an accounting principle that has a material effect on the financial statements.

Rare exception: b. Unusual circumstances may justify a departure from GAAP if compliance would cause the financial statements to be misleading.

(1) Interpretations of the Code specifically recognize *new legislation and new forms of business transactions* as occasions that might justify a departure from GAAP.

(2) An unusual degree of materiality or the existence of conflicting industry practices would not justify departure from GAAP.

(3) The departure, when justified, must be described and explained.

Confidential Information

6. **Confidential Client Information Rule**

a. A member in public practice shall not disclose any confidential client information without the specific consent of the client.

b. *Exceptions*—A member is obligated to disclose confidential information even without the consent of the client in the following circumstances:

(1) A member must disclose confidential client information if necessary to comply with a validly issued subpoena or summons.

(a) The member is not required to notify the client that its records have been subpoenaed or that a summons related to the client's records has been issued. The member may wish to consult with legal counsel to determine the validity and enforceability of the subpoena or summons and the specific client information required to be provided. The member may also wish to consult with his or her state board of accountancy.

(2) A member must disclose confidential information as a part of a quality review of the member's professional practices authorized by the AICPA (i.e., a request for confidential information by a state CPA society voluntary quality control review panel). Peer review

(3) A member must disclose confidential client information in response to any inquiry either made by the ethics division or the trial board of the AICPA or by a duly constituted investigative or disciplinary body of a state CPA society, or under authority of state statutes.

(4) Your legal defense team (when client is suing you)

**PASS KEY**

The examiners often ask to whom a CPA may disclose client audit documentation without consent of the client. Memorize the above three paragraphs and you will have no problem with such a question on your exam.

Contingent Fees

7. **Contingent Fees Rule** GR: Not allowed

a. A contingent fee is established for performing services where:

(1) No fee is charged unless a specific finding or result is obtained, *or*

(2) The fee amount is dependent upon the finding or result obtained.

b. Contingent fees are specifically prohibited for audits and reviews of financial statements or examinations of prospective financial information. In addition, a member in public practice is prohibited from preparing an original or amended tax return or claim for a tax refund for a contingent fee for any client.

c. Contingent fees are permitted in the following cases:

(1) Fees are not regarded as being contingent when they are fixed by courts or other public authorities or in tax matters, if they are based on the results of court proceedings or the findings of governmental agencies (e.g., a contingent fee is permitted when representing a client in an examination of a tax return by an IRS agent).

(2) Contingent fees are permitted for compilations of financial statements expected to be used by third parties only if the member includes a statement that the member is not independent.

Discreditable Acts

## 8. Acts Discreditable Rule

a. A member shall not commit an act discreditable to the profession.

b. The following acts are discreditable to the profession:

* (1) Failure to return records to a client after the client makes demand.

(2) Determination by a court or administrative agency of discrimination or harassment in public practice.

(3) Failing to follow applicable standards or procedures in government audits unless the member discloses that the standards were not followed and the reasons for noncompliance.

(4) Negligence in preparing financial statements or records.

(5) Failing to follow GAAS and other applicable standards of government agencies unless the member discloses that the standards were not followed and the reasons for noncompliance.

(6) Solicitation or disclosure of CPA Examination questions and answers.

(7) Failure to timely file a personal or firm tax return or to timely remit payroll or other taxes collected on behalf of others.

(8) Failure to follow regulatory requirements (where applicable) prohibiting the use of certain types of indemnification and limitation of liability provisions.

(9) Promotion or marketing of the member's abilities to provide professional services or making claims about the member's experience or qualifications in a manner that is false, misleading, or deceptive. This includes any representation about CPA licensure or any other professional certification or accreditation that is not in compliance with the requirements of the relevant licensing authority or designating body.

(10) A member whose employment relationship is terminated shall not take or retain (a) originals or copies (in any format) from the firm's client files; or (b) proprietary information without the firm's permission, unless the member has a contractual arrangement with the firm allowing such action.

(11) Disclosure of confidential information obtained from a prospective client or non-client without consent.

Solicitation

## 9. Advertising and Other Forms of Solicitation Rule = OK

a. A member in public practice shall not seek to obtain clients by advertising or other forms of solicitation in a manner that is false, misleading, or deceptive.

b. Advertisements and solicitations are misleading or deceptive if they:

Not allowed

(1) Create false or unjustified expectations of favorable results.

(2) Imply the ability to influence a court, regulatory agent or official.

(3) Intentionally underestimate fees.

(4) Would mislead or deceive a reasonable person.

Commissions

Referral Fees

## 10. Commissions and Referral Fees Rule = Impair independence

a. A member in public practice shall not for a commission recommend or refer to a client any product or service when the member or the member's firm also performs for that client:

(1) An audit or review of financial statements.

(2) A compilation of financial statements expected to be used by third parties, when the member does not disclose a lack of independence.

(3) An examination of prospective financial information.

OK
- Compilation
- Advisory
- Tax

Must disclose permitted commissions

b. A member performing other services not prohibited above may receive a commission, but the commission must be disclosed to the client.

c. A member who receives a referral fee for recommending another CPA or pays a referral fee to obtain a client must disclose this to the client.

Size
- Sole proprietor
- More than one

**11. Form of Organization and Name Rule**

**a. The Use of Misleading Firm Names Is Not Allowed**

(1) A firm may not designate itself as "Members of the American Institute of Certified Public Accountants" unless all of its CPA owners are members of the Institute.

(2) A firm may not designate itself as "CPAs" unless all of its owners are CPAs.

(3) The ideal designation following the firm name would be "CPAs, Members AICPA," if all owners were both CPAs and members of the AICPA.

(4) A firm may continue to use the names of one or more past owners.

(5) If all partners except one have died or left the firm, the remaining partner may continue to practice under the partnership name for up to two years after becoming a sole practitioner.

**b. Ownership of CPA Firms**

**(1) CPA Ownership** = Over 50% owned by CPAs

(a) A majority of the ownership, both in financial interests and in voting rights, must belong to CPAs. Any non-CPA owner must be actively engaged as a firm member in providing services to the firm's clients.

(b) A CPA must have ultimate responsibility for all services provided by the firm and by each business unit providing attest and compilation services and other services governed by Statements on Auditing Standards (SAS) or Statements on Standards for Accounting and Review Services (SSARS).

**(2) Non-CPA Owners**

(a) Non-CPA owners can use the title, "principal," "owner," "officer," "member," or "shareholder," or any other title permitted by state law, but not hold themselves out to be CPAs.

(b) Owners shall own their equity in their own right and be the beneficial owners of the equity capital ascribed to them.

**c. Use of CPA Title in Private Industry**

A CPA employee in private industry may use the designation CPA in signing a report only if the use of that designation does not imply to readers of the report that the CPA is independent.

(1) It is advisable to indicate one's own employment title within the private firm.

## D. Conceptual Framework

### 1. Background

The AICPA Code of Professional Conduct includes principles, rules, and interpretations. The conceptual frameworks are applied when none of the other three components provide adequate guidance or in a situation in which there is a threat or threats to complying with the rules.

| PASS KEY |
|---|
| The rules and interpretations portion of the AICPA Code of Professional Conduct seek to address many situations; however, they cannot address all relationships or circumstances that may arise. Thus, in the absence of an interpretation that addresses a particular relationship or circumstance, a member should apply the appropriate conceptual framework approach. |

a. There are three conceptual frameworks included in the AICPA Code of Professional Conduct:

**(1) Conceptual Framework for Members in Public Practice**

Members in public practice render attest, tax, and management advisory services.

**(2) Conceptual Framework for Independence**

Members in public practice are required to apply the Conceptual Framework Approach for Independence when faced with threats to independence.

**(3) Conceptual Framework for Members in Business**

Members in business are employed or engaged on a contractual or volunteer basis in a(n) executive, staff, governance, advisory, or administrative capacity in such areas as industry, the public sector, education, the not-for-profit sector, and regulatory or professional bodies (e.g., controller). This does not include a member engaged in public practice.

b. A member may have multiple roles, such as a member in business and a member in public practice. In such circumstances, the member should consult all applicable parts of the code and apply the most restrictive provisions.

c. The conceptual framework approach requires entities to:

(1) Identify threats to compliance with the fundamental principles listed above.

(2) Evaluate the significance of the threat.

(3) Apply safeguards to eliminate threats or reduce threats to an acceptable level, whenever possible.

The acceptable level is the level at which a reasonable and informed third party who is aware of the relevant information would be expected to conclude that a member's compliance with the rules is not compromised.

### 2. Threats to Compliance With the Fundamental Principles

Threats to compliance with the fundamental principles may fall into one or more threat categories, as shown in the table below.

(The threat categories are virtually the same among the conceptual frameworks. Generally, the difference in definition is that threats related to members in public practice reference the *client*, threats to members in business reference the *employing organization*, and threats to independence reference the *attest client*. Where slight differences exist, the wording is italicized.)

| Threat Categories | CONCEPTUAL FRAMEWORK FOR Members in Public Practice | Members in Business | Independence |
|---|---|---|---|
| *Adverse Interest threat* Objectivity | The threat that a member will not act with objectivity because the member's interests are opposed to the *client's interests*. | The threat that a member will not act with objectivity because the member's interests are opposed to the interests of the *employing organization*. | The threat that a member will not act with objectivity because the member's interests are in opposition to the interests of an *attest client*. |
| *Advocacy Threat* Compromised | The threat that a member will promote a *client's* interests or position to the point that his or her *objectivity or independence* is compromised. | The threat that a member will promote an *employing organization's* interests or position to the point that his or her *objectivity* is compromised. | The threat that a member will promote an *attest client's* interests or position to the point that his or her *independence* is compromised. |
| *Familiarity Threat* Sympathetic | The threat that, due to a long or close relationship with a *client*, a member will become too sympathetic to the *client's interests* or too accepting of the *client's work* or product. | The threat that, due to a long or close relationship with *a person or an employing organization*, a member will become too sympathetic to their interests or too accepting of the *person's work or employing organization's* product or *service*. | The threat that, because of a long or close relationship with an *attest client*, a member will become too sympathetic to the *attest client's* interests or too accepting of the *attest client's work* or product. |
| *Management Participation Threat* Acting as management | The threat that a member will take on the role of *client* management or otherwise assume management responsibilities; *such may occur during an engagement to provide non-attest services*. | N/A | The threat that a member will take on the role of *attest* client management or otherwise assume management responsibilities for an *attest* client. |
| *Self-Interest Threat* Benefits | The threat that a member could benefit, financially or otherwise, from an interest in, or relationship with, *a client* or persons associated with the *client*. | The threat that a member could benefit, financially or otherwise, from an interest in, or relationship with, the *employing organization* or persons associated with the *employing organization*. | The threat that a member could benefit, financially or otherwise, from an interest in, or relationship with, an *attest client* or persons associated with the *attest client*. |
| *Self-Review Threat* Evaluate your own work | The threat that a member will not appropriately evaluate the results of a previous judgment made or service performed or supervised by the member or an individual in the *member's firm* and that the member will rely on that service in forming a judgment as part of *another service*. | The threat that a member will not appropriately evaluate the results of a previous judgment made or service performed or supervised by the member, or an individual in the *employing organization* and that the member will rely on that service in forming a judgment as part of *another service*. | The threat that a member will not appropriately evaluate the results of a previous judgment made, or service performed or supervised by the member or an individual in *the member's firm* and that the member will rely on that service in forming a judgment as part of an *attest engagement*. |
| *Undue Influence Threat* Subordinate judgment | The threat that a member will subordinate his or her judgment to an individual associated with *a client* or any relevant third party due to that individual's reputation or expertise, aggressive or dominant personality, or attempts to coerce or exercise excessive influence over the member. | The threat that a member will subordinate his or her judgment to that of an individual associated with *the employing organization* or any relevant third party due to that individual's position, reputation or expertise, aggressive or dominant personality, or attempts to coerce or exercise excessive influence over the member. | The threat that a member will subordinate his or her judgment to that of an individual associated with *an attest client* or any relevant third party due to that individual's reputation or expertise, aggressive or dominant personality, or attempts to coerce or exercise excessive influence over the member. |

### 3. Evaluate the Significance of the Threat

In evaluating the significance of an identified threat, the member should determine whether a threat is at an acceptable level. Members should consider both qualitative and quantitative factors when evaluating the significance of a threat, including the extent to which existing safeguards already reduce the threat to an acceptable level.

If the member evaluates the threat and concludes that a reasonable and informed third party who is aware of the relevant information would be expected to conclude that the threat does not compromise a member's compliance with the rules, the threat is at an acceptable level, and the member is not required to evaluate the threat any further under the conceptual framework approach.

### 4. Safeguards That May Eliminate or Reduce Threats

If, in evaluating the significance of an identified threat, the member concludes that the threat is not at an acceptable level, the member should apply safeguards to eliminate the threat or reduce it to an acceptable level, if possible.

a. Safeguards fall into one of the following categories for the conceptual framework for members in public practice and conceptual framework for independence:

(1) Safeguards created by the profession, legislation, or regulation

(2) Safeguards implemented by the client: It is not possible to rely solely on safeguards implemented by the client to eliminate or reduce significant threats to an acceptable level.

(3) Safeguards implemented by the firm: This includes policies and procedures to implement professional and regulatory requirements.

b. Safeguards fall into one of the following categories for the conceptual framework for members in business:

(1) Safeguards created by the profession, legislation, or regulation.

(2) Safeguards implemented by the employing organization.

**AICPA CODE OF PROFESSIONAL CONDUCT VS. IFAC CODE OF ETHICS**

The conceptual framework approach in the AICPA Code of Professional Conduct is very similar to the conceptual framework approach in the IFAC Code of Ethics.

**EXAMPLE**

Example of **adverse interest threat** includes:

- The member or *client/attest client/employing organization* commencing litigation against the other or expressing the intent to commence litigation.

Examples of **advocacy threat** include:

- A member endorses a *client's* services or products.
- The member gives or fails to give information that the member knows will unduly influence the conclusions reached by an external service provider or other third party.
- A member promotes the *attest client's* securities as part of an initial public offering.

Examples of **familiarity threat** include:

- A member's close friend who is employed by the *client/attest client*.
- A member regularly accepts gifts or entertainment from a vendor or customer of the *employing organization*.

Examples of **management participation threat** include:

- A member serves as an officer or a director of the *attest client*.
- A member accepts responsibility for designing, implementing, or maintaining internal controls for the *attest client*.

(continued)

(continued)

Examples of **self-interest threat** include:

- A member or his or her firm relies excessively on revenue from a single *client/attest client*.
- A member is eligible for a profit or other performance-related bonus at the *employing organization*, and the value of that bonus is directly affected by the member's decisions.

Examples of **self-review threat** include:

- The member performs bookkeeping services for a *client*.
- When the member performs an internal audit procedure at the *employing organization*, the member reviews work that he or she previously performed in a different position.

Examples of **undue influence threat** include:

- The client indicates that it will not award additional engagements to the firm if the firm continues to disagree with the *client* on an accounting or tax matter.
- A member is pressured to become associated with misleading information.
- *Attest client's* management pressures the member to reduce necessary audit procedures in order to reduce audit fees.

**EXAMPLE**

Examples of safeguards **created by the profession, legislation, or regulation**:

- Education and training requirements on ethics, independence, and/or professional responsibilities.
- Continuing education requirements on independence and/or ethics.
- Professional standards and the threat of discipline.
- Legislation establishing prohibitions and requirements for employees.
- Competency and experience requirements for professional licensure.
- Professional resources, such as hotlines, for consultation on ethical issues.

Examples of safeguards **implemented by the client** that would operate in combination with other safeguards are as follows:

- The client has personnel with suitable skill, knowledge, or experience who make managerial decisions about the delivery of professional services and makes use of third-party resources for consultation as needed.
- The tone at the top emphasizes the client's commitment to fair financial reporting and compliance with the applicable laws, rules, regulations, and corporate governance policies.
- A governance structure, such as an active audit committee, is in place to ensure appropriate decision making, oversight, and communications regarding a firm's services.

Examples of safeguards **implemented by the firm**:

- Documented policies regarding the identification of threats to compliance with the rules, the evaluation of the significance of those threats, and the identification and application of safeguards that can eliminate identified threats or reduce them to an acceptable level.
- Discussion of independence and ethics issues with the audit committee or others responsible for the client's governance.
- The removal of an individual from an attest engagement team when that individual's financial interests or relationships pose a threat to independence or objectivity.
- Client acceptance and continuation policies that are designed to prevent association with clients that pose a threat that is not at an acceptable level to the member's compliance with the rules.
- Policies and procedures that are designed to monitor the firm's, partner's, or partner equivalent's reliance on revenue from a single client and that, if necessary, trigger action to address excessive reliance.

Examples of safeguards **implemented by the employing organization** are as follows:

- A tone at the top emphasizing a commitment to fair financial reporting and compliance with applicable laws, rules, regulations, and corporate governance policies.
- An audit committee charter, including independent audit committee members.
- Internal policies and procedures requiring disclosure of identified interests or relationships among the employing organization, its directors or officers, and vendors, suppliers, or customers.
- Human resource policies and procedures stressing the hiring and retention of technically competent employees.

## II. THE SARBANES-OXLEY ACT OF 2002

Sarbanes-Oxley Act

In the wake of the collapse of Enron and WorldCom corporations and the restatement of financial statements of a number of other SEC reporting companies, Congress passed the Sarbanes-Oxley Act (SOX).

### A. SOX Title I—*Public Company Accounting Oversight Board (PCAOB)*

Public Company Accounting Oversight Board

1. Title I of the Sarbanes-Oxley Act provides for a Public Company Accounting Oversight Board comprised of five members. Two members must be CPAs and three members cannot be CPAs.

2. The board is subject to oversight by the SEC and has the duty to:

CPA firms that audit public companies

   a. Register public accounting firms that prepare audit reports for issuers;
   b. Establish rules relating to the preparation of audit reports for issuers; and
   c. Conduct inspections, investigations, and disciplinary proceedings concerning registered public accounting firms.

**PASS KEY**

The PCAOB must conduct annual inspections of registered public accounting firms that regularly provide audit reports for more than 100 issuers. Registered public accounting firms that provide audit reports for 100 or fewer issuers must be inspected at least once every three years.

3. **Registration With PCAOB—*Only Registered Firms Can Audit SEC Issuer*** = Public company

   Only a "registered public accounting firm" (i.e., an accounting firm registered with the PCAOB) may prepare audit reports for an SEC issuer.

   a. The application for registration must be updated annually and contain:
      (1) The names of issuers audited in the preceding and current year, including annual fees received for such audits;
      (2) A statement of the firm's quality control policies;
      (3) A list of all firm accountants who will participate in the audits;
      (4) Legal or disciplinary proceedings pending against the firm; and
      (5) Disclosures filed by audited issuers concerning accounting disagreements between the issuer and the firm related to audits.
   b. Each registered firm must consent to cooperate with any request from the Oversight Board concerning testimony or production of documents.

4. **Each Registered Firm Must Adhere to the Following Auditing Standards**
   a. Audit documentation must be maintained for seven years (criminal penalties will apply for failure to retain papers for at least seven years);
   b. Provide a concurring or second partner review of each audit report; and
   c. Describe in audit reports the scope of the testing of the issuer's internal control structure and procedures.

5. **Quality Control Standards Required of Registered Firms**

   Registered accounting firms must monitor professional ethics and independence from issuers that they audit and must supervise audit work.

6. **Investigations and Sanctions**

The board can conduct investigations of wrongdoing by registered firms or associated persons of those firms. If a firm or associated person is found to have violated the provisions of the Sarbanes-Oxley Act, the rules of the PCAOB, or the provisions of securities laws relating to the preparation and issuance of audit reports, the PCAOB can impose the following sanctions:

a. Temporary suspension or permanent revocation of PCAOB registration;

b. Temporary or permanent suspension or bar of a person from associating with a registered firm;

c. Temporary or permanent limitation on the activities, functions or operations of a firm or person;

d. Civil monetary penalties of no more than $750,000 for individuals and $15,000,000 for registered firms for intentional or knowing conduct, including reckless conduct, that results in violations or repeated instances of negligent conduct; and penalties of no more than $100,000 for individuals and $2,000,000 for registered firms for other violations;

e. Censure;

f. Require professional education or training; and

g. Any other PCAOB approved sanction.

## B. SOX Title II—*Auditor Independence*

1. **Prohibited Services** = When auditing "issuer" (public company)

a. A registered public accounting firm that performs SEC audits may not provide the following services to the audit client:

(1) Bookkeeping;

(2) Financial information systems design and implementation;

(3) Appraisal and valuation services;

(4) Actuarial services;

(5) Management functions or human resources services;

(6) Internal audit outsourcing services;

(7) Services as a broker, dealer, investment adviser, or investment banker;

(8) Legal services; and

(9) Expert services unrelated to the audit.

b. Tax services are permissible if preapproved by the audit committee.

2. **Audit Committee Preapproval** = When auditing "issuer"

All auditing services and permitted non-audit services provided by an auditor to an issuer should be preapproved by the audit committee of the issuer.

Audit Partner Rotation

3. **Audit Partner Rotation** = When auditing "issuer"

The lead audit or coordinating partner and the reviewing partner must rotate off the audit every five years.

4. **Registered Firms Must Report to Audit Committees**

Registered firms must report the following to the audit committees of audited corporations:

a. The critical accounting policies and practices to be used;

b. Alternative accounting treatments discussed with the corporation's management, the ramifications of the alternatives, and the treatment the firm prefers; and

c. Material written communications between the audit firm and management, including a schedule of unadjusted audit differences and any management letter.

5. **Conflicts of Interest**

The audit firm cannot have employed the issuer's CEO, CFO, Controller, or Chief Accounting Officer, or any person serving in an equivalent position for a one-year period preceding the audit. "Cool-off" period

### C. SOX Title III, Section 303—*Improper Influence on Conduct of Audits*

It is unlawful for any officer or director of an issuer, or any person acting under the direction of an officer or director, to take any action to fraudulently influence, coerce, manipulate, or mislead any independent CPA engaged in the performance of an audit of the financial statements of the issuer for the purpose of rendering such financial statements materially misleading.

### D. SOX Title IV—*Enhanced Financial Disclosures*

1. **Disclosures in Periodic Reports**

All financial reports required to be prepared in accordance with GAAP must reflect all material adjustments that have been identified by a registered firm.

2. **Off-balance Sheet Transactions**

Annual and quarterly financial reports must disclose all material off-balance sheet transactions and other relationships with unconsolidated entities that have a material current or future effect on the financial condition of the issuer.

3. **Disclosure of Transactions—*Officers, Directors, or 10%+ Shareholders*** = Related parties

a. Any officer, director, or owner of more than 10% of any equity security must file a report indicating how many shares they own within 10 days after becoming an officer, director, or more than 10% owner.

b. A change in ownership must be filed within two days of such change.

4. **Management Assessment of Internal Controls**

Form 10-K and 10-Q reports must include an **internal control report stating:**

a. Management's responsibility for establishing an adequate internal control structure and procedure for financial reporting; and

b. An assessment of the effectiveness of the current year's control structure. Auditors are required to attest to management's assessment of the effectiveness of internal control over financial reporting.

Code of Ethics

5. **Code of Ethics for Senior Financial Officers**

a. The SEC requires each issuer to disclose in Form 10-K and 10-Q whether or not they have a code of ethics for senior financial officers. If they do not have a code, they must state their reasons why.

b. Changes to the code of ethics must be immediately disclosed either by filing Form 8-K or by dissemination over the Internet or other electronic means.

6. **Disclosure of Audit Committee Financial Expert**

The SEC requires issuers to disclose along with their Form 10-K and 10-Q filings whether or not (and if not, why not) the audit committee has at least one member who is a financial expert.

a. A financial expert qualifies through:

(1) education and experience as a principal financial officer, principal accounting officer, controller, public accountant or auditor, or experience in one or more positions that involve the performance of similar functions;

(2) experience actively supervising a principal financial officer, principal accounting officer, controller, public accountant, auditor, or person performing similar functions, or experience overseeing or assessing the performance of companies or public accountants with respect to the preparation, auditing, or evaluation of financial statements; or

(3) other relevant experience.

b. The knowledge of a financial expert should include:

(1) an understanding of financial statements and generally accepted accounting principles;

(2) an ability to assess the general application of such principles in connection with the accounting for estimates, accruals, and reserves;

(3) experience preparing, auditing, analyzing, or evaluating financial statements that present a breadth and level of complexity of accounting issues that are generally comparable to the breadth and complexity of issues that can reasonably be expected to be raised by the registrant's financial statements, or experience actively supervising one or more persons engaged in such activities;

(4) an understanding of internal controls and procedures for financial reporting; and

(5) an understanding of audit committee functions.

7. **Real Time Issuer Disclosures**

Issuers filing Form 10-K and 10-Q reports must disclose to the public on a "rapid and current basis" and in plain English additional information concerning the issuer's material changes in financial condition.

## III. U.S. SECURITIES AND EXCHANGE COMMISSION (SEC)

Rule 2-01 of SEC Regulation S-X outlines the independence rules that apply to the auditors of SEC registrants. The SOX independence rules have been incorporated into these rules.

### A. Principles of Independence

When considering whether a circumstance raises independence concerns, the SEC looks to whether a client relationship or a service provided to an audit client:

1. Creates a mutual or conflicting interest between the auditor and client.
2. Results in the auditor acting as management or an employee of the audit client.
3. Places the auditor in a position of auditing his or her own work.
4. Places the auditor in a position of being an advocate for the audit client.

## B. Circumstances That Impair Auditor Independence

Rule 2-01 states that an accountant is not independent with respect to an audit client if the accountant is not, or a reasonable, knowledgeable investor would conclude that the accountant is not, capable of exercising objective and impartial judgment on all issues related to the accountant's engagement. The following is a non-exhaustive list of circumstances that impair auditor independence.

### 1. Financial Relationships

#### a. Investments in Audit Clients

All direct investments and material indirect investments in audit clients by the firm, any covered person in the firm, or any member of his or her immediate family impair auditor independence. Such investments include:

(1) Direct investments in stocks, bonds, notes, options, or other securities of the audit client, including direct investments held through an intermediary.

(2) Beneficial ownership of more than 5% of an audit client's equity securities.

(3) Service as a voting trustee of a trust or executor of an estate containing securities of the audit client, unless there is no authority to make investment decisions for the trust or estate.

(4) Material indirect investment in the audit client.

**PASS KEY**

Under SEC rules, covered persons include the audit engagement team; the audit chain of command, which includes all persons who supervise or have direct management responsibility for the audit, all persons who evaluate the performance or recommend the compensation of the audit engagement partner, and all persons who provide quality control or other oversight of the audit; any other partner, principal, shareholder, or managerial employee of the firm who provided ten or more hours of non-audit services to the audit client or expects to provide ten or more hours of non-audit services to the client on a recurring basis; any other partner, principal, or shareholder from an office of the accounting firm in which the lead audit engagement partner primarily practices in connection with the audit.

#### b. Other Financial Interests in Audit Clients

The following financial interests in the audit client by the firm, any covered person in the firm, or any member of his or her immediate family impair auditor independence:

(1) Loans to or from an audit client, or an audit client's officers, directors, or beneficial owners of more than ten percent of the audit client's equity securities.

(a) This rule excludes loans obtained from financial institutions under normal lending circumstances, such as automobile loans or leases, loans fully collateralized by the cash surrender value of life insurance, loans fully collateralized by cash deposits at the financial institution, and mortgage loans on a primary residence obtained before the covered person was a covered person.

(2) Savings and checking account balances that exceed the amount insured by the FDIC. $250,000

(3) Broker-dealer accounts if the account includes assets other than cash or securities, or the amount in the account exceeds the insured amount.

(4) Futures commission merchant accounts.

(5) Credit card balances in excess of $10,000.

(6) Insurance products issued by an audit client.

(7) Financial interest in an investment company complex that includes an audit client.

**c. Exceptions**

Investments or other financial interests in an audit client will not impair independence in the following circumstances:

(1) The financial interest is received through an unsolicited gift or inheritance and is disposed of as soon as practicable, no later than 30 days after the person has knowledge of and the right to dispose of the financial interest.

(2) In a new audit engagement, any person with a financial interest that would impair auditor independence disposes of the financial interest before the earlier of: 1) the signing of the initial engagement letter or other agreement to provide services, or 2) the commencement of any audit, review, or attestation services.

(3) An immediate family member of a covered person has a financial interest that would impair independence as an unavoidable consequence of participation in his or her employer's employee compensation or benefits program and the financial interest is disposed of as soon as practicable, no later than 30 days after the person has knowledge of and the right to dispose of the financial interest.

**d. Audit Clients' Financial Interests**

The following financial relationships of the audit client impair auditor independence.

(1) Investment by the audit client in the accounting firm.

(2) Engagement of the accounting firm by the audit client to act as an underwriter, broker-dealer, market-maker, promoter, or analyst.

**2. Employment Relationships**

*Employment relationships* between the accountant and the audit client during the engagement period that impair auditor independence include:

a. Employment of a covered person by the audit client or service on the board of directors or other management or governing body of the audit client.

b. Employment of a close family member of a covered person in an accounting or financial reporting role at the audit client.

c. Employment at the audit client of a former member of the audit engagement team in an accounting role or a financial oversight role, unless the individual:

(1) Does not influence the accounting firm's operations or financial policies,

(2) Has no capital balances in the accounting firm, and

(3) Has no financial arrangement with the accounting firm, other than one providing for regular payment of a fixed dollar amount (not dependent on the firm's revenues, profits, or earnings) from:

(a) A fully funded retirement plan or similar vehicle, or

(b) That is immaterial to the former professional employee (only in the case of a former employee who was not a partner, principal, or shareholder and who has been disassociated from the firm for more than five years).

d. Employment at the audit client of a former member of the audit engagement team in a financial oversight role, if the individual was a member of the engagement team during the one-year period preceding the commencement of audit procedures (the "cooling off" period).

**PASS KEY**

SEC and SOX rules prohibit an accounting firm from auditing an issuer's financial statements if certain members of management of the issuer (members in financial oversight roles such as the CEO, CFO, or controller) had been members of the accounting firm's audit engagement team within the one-year period preceding the commencement of audit procedures (the required "cooling off" period). The audit engagement team includes the lead partner, the concurring partner, and other individuals who provided more than ten hours of service during the annual audit period.

e. Employment at the accounting firm of a former employee of the audit client, unless the individual does not participate in, and is not in a position to influence, the financial statement audit of the audit client covering any period in which the individual was employed by or associated with the audit client.

**3. Business Relationships**

Direct or material indirect *business relationships* between the firm or any covered person in the firm and an audit client or persons participating in decision making for an audit client (officers, directors, substantial stockholders) impair auditor independence.

**4. Non-audit Services**

Auditor independence is impaired if any of the following *non-audit services* are provided during the audit and professional engagement period:

a. Bookkeeping or other services related to the accounting records or financial statements of the audit client;

b. Financial information systems design and implementation;

c. Appraisal or valuation services, fairness opinions, or contribution-in-kind reports;

d. Actuarial services;

e. Internal audit outsourcing services;

f. Management functions or human resources;

g. Broker or dealer, investment adviser, or investment banking services;

h. Legal services (including representing an audit client before a tax court, district court, or federal court of claims);

i. Expert services unrelated to the audit.

**5. Contingent Fees**

Independence is impaired by *contingent fee* or commission arrangements in which the accountant provides any service or product to the audit client for a contingent fee or a commission, or receives a contingent fee or commission from an audit client.

6. **Partner Rotation**

Failure of the lead audit partner and the concurring partner on the audit engagement team to rotate off the audit engagement after five years or failure of other audit partners to rotate off the audit engagement after no more than seven years impairs independence. (Other audit partners include partners who have responsibility for decision making on significant auditing, accounting or reporting matters, or who maintain regular contact with management and the audit committee of the client.)

a. **Required "Time Out" Period**

Stay off job

Lead partners and concurring partners are subject to a five-year *"time out"* period before returning to an engagement. Other audit partners are subject to a two-year "time out" period.

b. **Small Firms**

*Small accounting firms* with fewer than five clients who are issuers and have fewer than ten partners may be exempted from the partner rotation requirement.

7. **Audit Committee Administration of the Engagement**

Auditor independence is impaired when the audit committee fails to administer the engagement. Audit committees are required to preapprove all audit, review, or attest engagements and all permissible non-audit services, including tax compliance, tax planning, and tax advice either on a case-by-case basis or pursuant to preestablished policies and procedures.

a. **Preapproval Not Required**

*Preapproval is not required* for non-audit services that do not exceed five percent of total revenues from the audit client during the fiscal year when services are provided, as long as the non-audit services are promptly brought to the attention of the audit committee and approved before the completion of the audit.

b. **Required Auditor Reporting to the Audit Committee**

The auditor of an issuer's financial statements is required to report certain matters to the issuer's audit committee, including:

(1) Critical accounting principles and practices used,

(2) Alternative accounting treatments discussed with management, the ramifications of the use of the alternatives, and the treatment preferred by the audit firm,

(3) Material written communications between the audit firm and management, including the management letter and the schedule of unadjusted audit differences.

"SOAP"

8. **Compensation**

Auditor independence is impaired if an audit partner earns or receives *compensation* based on selling engagements to an audit client for services other than audit, review, and attest services. Audit partners include the lead audit partner, the concurring audit partner, and other audit partners who have responsibility for decision making on significant auditing, accounting, or reporting matters, or who maintain regular contact with management and the audit committee of the client.

## IV. PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD (PCAOB)

CPA firms that audit "issuers" (public companies)

### A. Interim Ethics and Independence Standards

The PCAOB has adopted Rules 101 (Independence) and 102 (Integrity and Objectivity) from the AICPA Code of Professional Conduct on an interim basis.

### B. PCAOB Independence Standards

In addition to the interim independence standards, the PCAOB's independence standards include the independence rules outlined in SOX and the SEC independence rules outlined above. The PCAOB has also issued the following independence standards. The collective PCAOB standards apply to all audits of issuers by registered firms.

1. **Responsibility Not to Knowingly or Recklessly Contribute to Violations**

   A person associated with a registered public accounting firm should not take or omit to take an action knowing, or recklessly not knowing, that the action or omission would contribute to a violation by the registered public accounting firm of the Sarbanes-Oxley Act, the rules of the PCAOB, securities laws, rules of the SEC, or professional standards.

2. **Auditor Independence**

   A registered public accounting firm and its associated persons must be independent of the firm's audit client throughout the audit and professional engagement period.

3. **Contingent Fees**

   A registered public accounting firm may not provide services or products for a contingent fee (i.e., those in which the amount of the fee is dependent upon the results of the services performed) or a commission, or receive from the audit client a contingent fee or commission.

4. **Tax Transactions**

   Registered public accounting firms may not provide to audit clients any tax services related to certain confidential or aggressive tax transactions.

5. **Tax Services for Persons in Financial Reporting Oversight Roles**

   Registered public accounting firms may not provide any tax services to corporate officers of audit clients, or to immediate family members of corporate officers.

6. **Audit Committee Preapproval of Certain Tax Services** = Do corp. tax return

   Proposed tax services and related fees must be communicated to the audit committee in writing. The potential effects of the services on the firm's independence should also be discussed with the audit committee, and this discussion must be documented.

7. **Audit Committee Preapproval of Non-audit Services Related to Internal Control Over Financial Reporting**

   Non-audit services related to internal control over financial reporting must be communicated to the audit committee in writing. The potential effects of the services on the firm's independence should also be discussed with the audit committee, and this discussion must be documented.

8. **Communication With the Audit Committee Concerning Independence**

   Before accepting an initial engagement with an issuer and at least annually for each issuer audit client, a registered public accounting firm must describe in writing to the audit committee of the issuer all relationships that may reasonably be thought to bear on independence, discuss the potential effects of those relationships on the audit firm's independence, and document the discussion. As part of the annual communication, the audit firm must affirm, in writing, that the audit firm is independent as of the date of the communication.

## V. DEPARTMENT OF LABOR *(DOL)*

The U.S. *Department of Labor* (DOL) has established guidelines for determining when a qualified public accountant is independent for the purpose of rendering an opinion on an employee benefit plan under the Employee Retirement Income Security Act of 1974 (ERISA).

### A. Independence Required

Auditor independence is required when auditing and rendering an opinion on the financial information required to be submitted to the Employee Benefits Security Administration of the DOL.

### B. Impairment of Independence

The following situations impair independence with respect to an employee benefit plan:

1. Any direct financial interest or a material indirect financial interest in the plan or the plan sponsor.
2. Connection to the plan or the plan sponsor as a promoter, underwriter, investment advisor, voting trustee, director, officer, or employee.
3. An accountant or a member of the accounting firm maintains financial records for the employee benefit plan.

### C. Independence Not Impaired

An accountant's independence is not impaired when:

1. A former officer or employee of the plan or plan sponsor is employed by the firm, the individual has completely disassociated from the plan or plan sponsor, and the individual does not participate in auditing the financial statements of the plan covering any period of his or her employment by the plan or plan sponsor.
2. The accountant or the accountant's firm was engaged by the plan sponsor during the period of the professional engagement with the employee benefit plan.
3. An actuary associated with the accountant or the accountant's firm rendered services to the plan.

## VI. IFAC CODE OF ETHICS FOR PROFESSIONAL ACCOUNTANTS

### A. Fundamental Principles of Professional Ethics

The IFAC's Code of Ethics for Professional Accountants outlines the following fundamental principles of professional ethics for professional accountants:

#### 1. Integrity

A professional accountant should be straightforward and honest in all professional and business relationships.

#### 2. Objectivity

Bias, conflict of interest, and the undue influence of others should not override professional or business judgment.

#### 3. Professional Competence and Due Care

A professional accountant should maintain professional knowledge and skill at a level that enables the accountant to provide competent and professional service to a client or employer, and should act diligently and in accordance with applicable technical and professional standards.

#### 4. Confidentiality

Confidential business information acquired from professional or business relationships should not be used for personal advantage and should not be disclosed to third parties without proper or specific authority unless there is a legal or professional right or duty to disclose the information.

#### 5. Professional Behavior

A professional accountant should comply with laws and regulations and should not take any action that discredits the profession.

### B. Conceptual Framework Approach

The IFAC's Code of Ethics is based on a conceptual framework approach, rather than a set of specific rules. Under the conceptual framework, entities are required to identify, evaluate, and address threats to compliance with the fundamental principles listed above. Whenever possible, safeguards should be applied to eliminate threats or reduce threats to an acceptable level.

#### 1. Threats to Compliance With the Fundamental Principles

Threats to compliance with the fundamental principles fall into one or more of the following categories:

##### a. Self-Interest Threat

The threat that a financial interest or other interest will inappropriately influence the accountant's judgment or behavior.

##### b. Self-Review Threat

The threat that an accountant will not appropriately evaluate the results of a previous judgment made or service performed by the accountant or by another individual in the accountant's firm.

##### c. Advocacy Threat

The threat that an accountant will advocate a client's or employer's position to the point where objectivity is compromised.

d. **Familiarity Threat**

The threat that an accountant will become too sympathetic to a client's or employer's interests or too accepting of their work due to a long or close relationship.

Undue influence threat

e. **Intimidation Threat**

The threat that an accountant will not act objectively because of actual or perceived pressures, including attempts to exercise undue influence over the accountant.

2. **Safeguards That May Eliminate or Reduce Threats**

Safeguards fall into one of the following categories:

a. Safeguards created by the profession, legislation, or regulation, including:

(1) Educational, training, and experience requirements for entry into the profession

(2) Continuing professional education requirements

(3) Professional standards

(4) Corporate governance regulations

(5) Professional or regulatory monitoring and disciplinary procedures

(6) External review by a legally empowered third party

b. Safeguards in the work environment.

## C. Independence Rules

The IFAC's Code of Ethics requires independence in all assurance engagements and states that independence requires:

1. **Independence of Mind**

*Independence of mind* allows the professional accountant to express conclusions without allowing influences to compromise professional judgment, thereby allowing the accountant to act with integrity, objectivity, and professional skepticism.

2. **Independence in Appearance**

*Independence in appearance* is achieved by avoiding facts and circumstances that would cause a reasonable and informed third party with knowledge of all relevant information to conclude that the firm's, or a member of the assurance team's, integrity, objectivity, or professional skepticism has been compromised.

3. **Conceptual Framework Approach to Independence**

When faced with independence issues, firms are required to apply the *conceptual framework approach.* Firms should evaluate the specific circumstances, the nature of the assurance engagement, and the identified threats to independence to determine whether it is appropriate to accept or continue an engagement, and to determine the safeguards required and whether an individual should be a member of the engagement team. Regular communication with the audit committee regarding independence is required.

## 4. Specific Circumstances and Relationships That Create Threats to Independence

The Code of Ethics for Professional Accountants describes specific circumstances and relationships that may create threats to independence and describes the safeguards that can be used to eliminate the threats or reduce them to an acceptable level. In general, these rules reflect the independence rules outlined by the AICPA, SOX, PCAOB, and SEC.

### a. Financial Interests

A direct *financial interest* or a material indirect financial interest in a financial statement audit client creates a threat to independence that can only be eliminated by disposing of the financial interest or removing the member of the engagement team with the financial interest from the engagement.

### b. Loans and Guarantees

A *loan* or *loan guarantee* to a firm, a member of the assurance team, or their immediate family from an assurance client that is a bank or other financial institution made under normal lending procedures generally does not create a threat to independence. A loan or loan guarantee to or from an assurance client that is not a bank or other financial institution creates a threat to independence that cannot be limited by any safeguard, unless the loan is immaterial to all parties.

### c. Close Business Relationships

A *close business relationship* between a firm or a member of the assurance team and the assurance client or its management creates a threat to independence that cannot be limited to an acceptable level by any safeguard, unless the financial interest is immaterial and the relationship is clearly insignificant to all parties.

### d. Family and Personal Relationships

Independence is threatened when an immediate or close family member of a member of the assurance team is a director, officer, or an employee of an assurance client in a position to exert direct and significant influence over the subject matter of the engagement. Safeguards to limit such a threat to an acceptable level include removing the individual from the assurance team or structuring the engagement so that the individual does not deal with matters that are the responsibility of the family member.

### e. Employment With Assurance Clients

Independence is threatened when a director, officer, or employee of the assurance client in a position to exert direct and significant influence over the subject matter of the engagement has been a member of the assurance team or partner of the firm. To reduce the threat to an acceptable level, the individual cannot be entitled to benefits or payments from the firm other than fixed predetermined arrangements (i.e., retirement benefits) and cannot participate or appear to participate in firm business or activities.

Independence is also threatened when an individual participates in an assurance engagement knowing that he or she may join the assurance client in the future. To reduce this threat to an acceptable level, a firm must have policies requiring individuals to notify the firm when entering into employment negotiations with an assurance client and such individuals must be removed from the engagement team.

**f. Recent Service With Assurance Clients**

Independence is threatened when a former officer, director, or employee of the assurance client in a position to exert direct and significant influence over the subject matter of the engagement is a member of the assurance team. Such individuals should not be assigned to the assurance team.

**g. Serving as an Officer or Director on the Board of an Assurance Client**

No safeguard can reduce or eliminate the threat to independence that exists when a partner or an employee of the firm or a network firm serves as an officer or director of an assurance client. In this situation, the firm cannot perform the assurance engagement.

**h. Partner Rotation**

Independence may be threatened when senior personnel serve on an assurance engagement for a long period of time. For audit clients that are public companies, the engagement partner and the individual responsible for the engagement quality control review should be periodically rotated off the engagement after a period of no more than seven years and should be subject to a time out period of normally two years.

**i. Provision of Non-assurance Services to Assurance Clients**

The following non-assurance services are such a significant threat to independence that they should not be provided to assurance clients:

(1) Authorizing, executing, or consummating a transaction on behalf of a client, or having the authority to do so.

(2) Determining which recommendation of the firm should be implemented by the client.

(3) Reporting in a management role to those charged with governance.

For financial statement audit clients that are public companies, accounting and bookkeeping services and valuation services are generally prohibited. Other non-assurance services may be performed as long as appropriate safeguards are put in place to limit any threats to independence. Audit committee preapproval of non-assurance services is one possible safeguard.

**j. Fees and Pricing**

Independence may be threatened when fees generated by a client represent a large portion of a firm's or a partner's total revenues, or when fees from prior services are overdue. Payment of overdue fees should be required before an assurance report is issued. Overdue fees may be the equivalent to a loan to a client.

Independence may also be threatened when a firm obtains an assurance client at a significantly lower fee level than that charged by the predecessor or quoted by other firms.

Contingent fees are prohibited for assurance engagements and for non-assurance services provided to assurance clients.

**k. Gifts and Hospitality**

A firm or member of the assurance team should not accept gifts or hospitality from an assurance client unless the value is clearly insignificant.

**l. Actual or Threatened Litigation**

Independence is threatened when litigation takes place, or is likely, between the firm or a member of the assurance team and the assurance client. If safeguards cannot reduce the threat to an acceptable level, the firm must withdraw from or refuse to accept the engagement.

**SUMMARY OF INDEPENDENCE STANDARDS**

| | *AICPA* | *SOX / PCAOB / SEC* | *DOL* | *IFAC* |
|---|---|---|---|---|
| | Standards for assurance engagements (issuer and nonissuer) | Standards for audits / reviews of issuers | Standards for audits of employee benefit plans | International Code of Ethics for assurance engagements |
| *The following items impair independence:* | | | | |
| Direct financial interest | ✓ | ✓ | ✓ | ✓ |
| Material indirect financial Interest | ✓ | ✓ | ✓ | ✓ |
| Nonfinancial institution loan to or from client | ✓ | ✓ | | ✓ |
| Employment at client of a former employee of the firm, unless the former employee cannot influence the firm and amounts owed to the former employee are immaterial | ✓ | ✓ | | ✓ |
| Employment at client of a former employee of the firm as the client's CEO, CFO, controller, etc., during the one-year period preceding the commencement of audit procedures | Permitted with appropriate safeguards | ✓ | | |
| Employment at client of immediate/close family member in a key position | ✓ | ✓ | | ✓ |
| Individual who participates in the engagement is seeking or discussing potential employment with the client or has been offered employment by the client, unless the individual notifies the firm and is removed from the engagement | ✓ | ✓ | | ✓ |
| Former employee of the client participates on the engagement team when the engagement covers any period of the individual's employment with the client | ✓ | ✓ | ✓ | ✓ |

| | *AICPA* | *SOX / PCAOB / SEC* | *DOL* | *IFAC* |
|---|---|---|---|---|
| ***Non-attest services:*** | | | | |
| Bookkeeping | ✓ | ✓ | ✓ | ✓ |
| Financial information systems design and implementation | ✓ | ✓ | | Permitted with appropriate safeguards |
| Appraisal and valuation services | ✓ | ✓ | | ✓ |
| Actuarial services | ✓ | ✓ | | Permitted with appropriate safeguards |
| Management (officer, director, or employee in management capacity) or human resources services | ✓ | ✓ | ✓ | ✓ |
| Internal audit | ✓ | ✓ | | Permitted with appropriate safeguards |
| Service as broker, dealer, investment advisor, or investment banker | ✓ | ✓ | ✓ | Permitted with appropriate safeguards |
| Legal services | ✓ | ✓ | | Permitted with appropriate safeguards |
| Expert services | ✓ | ✓ | | Permitted with appropriate safeguards |
| Overdue in payment of fees | ✓ | ✓ | | ✓ |
| Actual or threatened litigation | ✓ | ✓ | | ✓ |
| Contingent fees (audits, reviews, examinations) | ✓ | ✓ | | ✓ |
| Significant gifts from clients | ✓ | ✓ | | ✓ |
| Tax services related to confidential or aggressive tax transactions | | ✓ | | |
| Tax services to corporate officers of client or immediate family members | | ✓ | | |
| Partner compensated for selling services other than audit, review and attestation services | | ✓ | | |

| | *AICPA* | *SOX/PCAOB/SEC* | *DOL* | *IFAC* |
|---|---|---|---|---|
| *The following items are required for independence:* | | | | |
| Audit committee preapproval | | ✓ | | Not required, but may be used as a safeguard |
| Lead and concurring audit partner rotation | | ✓ | | ✓ |
| Other audit partner rotation | | ✓ | | |
| Reporting to audit committee/those charged with governance | ✓ (covered in SASs) | ✓ | | ✓ |

## VII. LICENSING AND DISCIPLINARY SYSTEMS

### A. State Boards of Accountancy

#### 1. Sole Power to License

a. Statutes in all 50 states grant to state boards of accountancy the sole power to license Certified Public Accountants.

b. Requirements for licensure vary from state to state. They require successful completion of the CPA examination and all or some of the following:

(1) A residency requirement;

(2) Educational requirements; and

(3) Experience requirements.

c. Since a state board is the only entity that can license a CPA, the state board is also the only entity with the power to suspend or revoke a CPA's license.

#### 2. Disciplinary Power of State Boards

**Disciplinary Systems**

a. Although each state determines what constitutes professional misconduct by a CPA sufficient to subject the CPA to disciplinary action, there are three broad categories of misconduct:

(1) Misconduct while performing accounting services (e.g., negligence, fraud, dishonesty, etc.);

(2) Misconduct outside the scope of accounting services (e.g., intoxication from alcohol or drugs that significantly impairs the accountant's ability to perform accounting services, insanity, etc.); and

(3) Criminal conviction (e.g., commission of a felony, failure to file tax returns, crimes relating to the practice of accounting, etc.).

b. After investigation of professional misconduct, the state board can conduct a formal hearing for possible disciplinary action.

(1) The board must find it was more likely than not that the accountant's actions constituted professional misconduct. Proof beyond a reasonable doubt (i.e., the standard in criminal cases) is not required.

(2) The accountant is entitled to due process of law.

(3) All adverse state board decisions are subject to judicial review.

c. There are five penalties that a state board of accountancy may impose for professional misconduct:

(1) Suspension or revocation of license;

(2) A monetary fine;

(3) A reprimand or censure;

(4) Probation; and

(5) Requirement for Continuing Professional Education (CPE) courses.

## B. American Institute of Certified Public Accountants (AICPA) and State CPA Societies

Clubs

### 1. The Code of Professional Conduct

The Code of Professional Conduct applies to all members of the AICPA. Many state CPA societies and state boards have incorporated all, or parts, of the Code.

Joint Ethics Enforcement Program

### 2. Joint Ethics Enforcement Program *(JEEP)*

a. The AICPA and state CPA societies have created the Joint Ethics Enforcement Program (JEEP) for enforcement of their codes of conduct by means of a single investigation and action.

b. Investigative information is shared between the AICPA and the state societies.

c. JEEP objectives also include the promotion of uniformity in the codes of conduct of the AICPA and state CPA societies and uniformity in enforcement and implementation of the codes of conduct.

### 3. Disciplinary Action by the AICPA and State CPA Societies

a. The AICPA and state CPA societies can sanction their members, but they cannot suspend or revoke a CPA's license.

b. The AICPA may suspend or terminate membership for failure to pay dues or failure to comply with membership retention requirements (e.g., practice-monitoring or continuing education requirements).

c. Membership can be suspended or terminated without a hearing for:

(1) Proof of conviction of a crime punishable by imprisonment for more than one year.

(2) Proof of conviction for willful failure to file any income tax return.

(3) Proof of conviction for filing a false or fraudulent income tax return or aiding in the preparation of a false or fraudulent income tax return of a client.

(4) Suspension or revocation of a member's license to practice public accounting as a disciplinary measure by a government authority.

d. The Professional Ethics Division of the AICPA investigates potential disciplinary matters and refers appropriate cases to the Joint Trial Board.

Joint Trial Board

(1) The Joint Trial Board may expel a member by two-thirds vote.

(2) The Joint Trial Board may suspend a member for up to two years or impose lesser sanctions by majority vote.

e. The following are grounds for Joint Trial Board sanctions:

(1) Violation of the bylaws or any rule of the Code of Conduct.

(2) Declaration by a court of having committed fraud.

(3) Determination by the Joint Trial Board of guilt for any act discreditable to the profession, or conviction of a criminal offense that tends to discredit the profession.

(4) Declaration by a court that the CPA is insane or incompetent.

(5) Suspension or revocation of a member's license to practice public accounting as a disciplinary measure by a government authority.

(6) Failure to cooperate with any Professional Ethics Division disciplinary investigation.

(7) Failure to comply with educational and remedial or corrective action determined to be necessary by the Professional Ethics Executive Committee within 30 days.

f. Notice of disciplinary action is published in a membership periodical (i.e., CPA Newsletter).

g. Possible sanctions include:

(1) Expulsion from the AICPA or state CPA society.

(2) Suspension of membership in the AICPA or state CPA society.

(3) Requirement that CPE courses be taken as a remedial measure.

## C. Securities and Exchange Commission (SEC)

### 1. Civil Penalties

a. The SEC may censure, suspend, or permanently revoke an accountant's right to practice before the SEC, including the right to sign documents required by the Securities Act of 1933 and the Securities Exchange Act of 1934.

b. Suspension or revocation of the right to practice before the SEC can occur if:

(1) The accountant lacks the qualifications to represent others,

(2) The accountant lacks character or integrity,

(3) The accountant acted unethically or unprofessionally,

(4) The accountant willfully violated federal security laws or regulations,

(5) The accountant was convicted of a felony or convicted of a misdemeanor involving moral turpitude, or

(6) The accountant's license to practice public accounting was suspended or revoked as a disciplinary measure by a government authority.

c. The SEC can issue cease and desist orders.

d. The sanctions and fines that can be imposed by the SEC are outlined in Title 1 of the Sarbanes-Oxley Act of 2002, as previously discussed in this text.

# Support auditor's opinion = AUDIT DOCUMENTATION

Audit Documentation

## I. GENERAL

Audit documentation (also referred to as "working papers" or "workpapers") is the principal record of audit procedures performed, evidence obtained, and conclusions reached.

### A. Purpose of Audit Documentation

- WPs belong to auditor
- May not disclose without client permission or court order

Audit documentation should provide:

1. Evidence of the basis for the auditor's report and the conclusion about the achievement of the overall objectives of the auditor, and
2. Evidence that the audit was conducted in accordance with generally accepted auditing standards and applicable legal and regulatory requirements.

### B. Audit Documentation Requirements

Audit documentation should: Indicate that accounting records = FS

1. Assist the engagement team in planning, conducting, and supervising the audit. Compliance with stds.
2. Show that the accounting records reconcile with the financial statements.
3. Enable the engagement team to show its accountability, emphasizing that the team is responsible for its work.
4. Provide a record of accumulated evidence, showing the procedures performed, evidence examined, and conclusions reached.
5. Be a record of matters of continuing significance to future audits of the same entity.
6. Enable the conduct of quality control reviews and inspections, including external inspections or peer reviews.
7. Assist an auditor who reviews a predecessor auditor's documentation.
8. Be prepared in enough detail so that an "experienced auditor" who has no previous connection with the audit can understand:

NET

   a. The nature, extent, and timing of the audit procedures performed;
   b. The results of the procedures performed and the evidence obtained;
   c. The significant findings or issues arising during the audit; and
   d. The conclusions reached, and significant judgments made to reach those conclusions.
9. Show who performed the work and the date the work was completed.
10. Show who reviewed the work performed and the date and extent of the review.
11. Include abstracts or copies of significant contracts or agreements.

| U.S. AUDITING STANDARDS VS. INTERNATIONAL STANDARDS ON AUDITING |
|---|
| ISAs do not require the auditor to include abstracts or copies of the entity's records in the audit documentation. |

12. Document discussions of significant findings or issues with management, those charged with governance, and others.

13. Document how the auditor addressed any information inconsistent with the auditor's final conclusion regarding a significant finding or issue.
14. Document the auditor's justification for a departure from a presumptively mandatory audit requirement and how alternative audit procedures achieved the intent of the requirement.
15. Document the performance and review of additional audit procedures or new conclusions after the date of the auditor's report.

## C. Retention and Completion

Audit documentation should be prepared on a timely basis.

### 1. Report Release Date

The "report release date" is defined as the date on which the auditor grants the client permission to use the report. Often, this is the date on which the report is delivered to the client. The auditor should document the report release date.

### 2. Document Retention

Keep WPs

a. **SAS Rules** *(nonissuers)* = 5 years

Auditing standards require that audit documentation be retained for at least **five years** from the report release date.

b. **PCAOB Rules** *(issuers)* = 7 years

The PCAOB requires auditors of public companies to keep audit documentation for **seven years** from the report release date.

### 3. Documentation Completion Date

The auditor is granted a certain window of time following the report release date in which to assemble the final audit documentation file. The end of this window is referred to as the "documentation completion date." After this date, existing documentation must not be deleted, and additions to the audit documentation must be documented as such.

Complete WPs

a. **SAS Rules** *(nonissuers)* = 60 days

Auditing standards require the final audit documentation file to be assembled within **60 days following the report release date.**

b. **PCAOB *Rules*** *(issuers)* = 45 days

The PCAOB defines the documentation completion date as **45 days following the report release date**, and requires preparation of an "engagement completion document" identifying all significant findings and issues. Also, under PCAOB standards, if work is performed by another auditor, the office issuing the report must obtain, review, and retain certain audit documentation from the other auditor.

### 4. Safekeeping of Audit Documentation

Reasonable precautions should be established for the safekeeping of audit documentation, as it is the proof that a professional audit was performed. The SOX Act of 2002 imposes tough penalties for failure to retain audit documentation or for the destruction of records.

a. The auditor should establish appropriate controls for audit documentation to protect its integrity, prevent unauthorized changes, etc.

**D. Nature and Extent of Audit Documentation**

Audit documentation may be in paper form, electronic form, or other media. Oral explanations alone are insufficient, but may be used for clarification of information included in the audit documentation.

The specific quantity, type, and content of audit documentation are based on the auditor's judgment. In determining the nature and extent of documentation for a specific area, the auditor should consider:

1. The size and complexity of the entity;
2. The nature of the specific auditing procedure;
3. The risk of material misstatement;
4. The significance of the evidence obtained;
5. The nature and extent of any exceptions identified;
6. The need to document conclusions that may not be obvious;
7. The audit methodology and tools used; and
8. The extent to which judgment was required in performing the work and evaluating the results.

**E. Specific Contents** Of workpapers

The form and content of audit documentation can vary, but it should be designed to meet the circumstances of the particular engagement. Generally, audit documentation will consist of a *permanent* or *continuous audit file* and a *current file.*

**1. Permanent (Continuous) File** = Carry forward from year to year

The permanent file includes audit documentation that has a continuing interest from year to year (such as contracts, pension plans, leases, stock options, bylaws, articles of incorporation, minutes of meetings, bond indentures, and internal information).

**2. Current File**

The current file contains all audit documentation applicable to the year under audit, and generally includes the following audit documentation:

a. The audit plan (audit program).

b. Financial statements and the auditor's report.

c. Working trial balance, adjusting journal entries, and reclassification entries.

d. Letters of confirmation and representation (e.g., letters from attorneys, a management representation letter, and confirmation responses).

e. Analyses, worksheets, issues memoranda, and schedules or commentaries prepared or obtained by the auditor. Note that related accounts, such as notes receivable and interest income, are often analyzed together.

f. Abstracts or copies of entity documents, such as contracts or agreements, examined to evaluate the accounting for significant transactions.

g. Summaries of significant audit findings or issues (see below), actions taken, and conclusions reached.

h. Records of tests of controls and substantive tests that include identification of specific items selected for testing (i.e., the source from which the items were selected and specific selection criteria).

### 3. Significant Audit Findings

Audit documentation should include significant audit findings, actions taken, and conclusions reached. Significant audit findings include matters that:

a. Are related to the selection and application of accounting principles (and the consistency with which they are applied), especially those involving complex or unusual transactions, or estimates and uncertainties.

b. Are related to matters that give rise to significant risks.

c. Are related to possible material misstatements in the financial statements.

d. Suggest a need to revise the auditor's previous risk assessment.

e. Cause significant difficulty in applying necessary audit procedures, or indicate the need for significant revision of planned audit procedures.

f. May result in modification of the auditor's opinion or the inclusion of an emphasis-of-matter paragraph in the auditor's report. Or "other matter paragraph"

### 4. Other Documentation Requirements

Specific audit documentation may also be required by other auditing standards, such as those related to the consideration of internal control, the consideration of fraud risk factors, etc.

### 5. Tickmarks

Auditors often use tickmarks, or symbols indicating the work that has been performed. Audit documentation should include explanations of any tickmarks used.

ABC Company
**Bank Reconciliation**
December 31, Year X

| | | | | | |
|---|---|---|---|---|---|
| Cash balance per bank | | | $ 275,000 | ✓ |
| Add: deposits in transit | | | | |
| 27 - Dec | $ 8,490 | Δ | | |
| 29 - Dec | 3,000 | Δ | | |
| 30 - Dec | 2,500 | Δ | 13,990 | И |
| Less: outstanding checks | | | | |
| #34582 | $ 2,456 | Φ | | |
| #34584 | 1,300 | Φ | | |
| #34585 | 1,414 | Φ | 5,170 | И |
| Cash balance per books | | | $ 283,820 | И # |

| TICKMARK LEGEND | |
|---|---|
| ✓ | Agreed to 12/31 bank statement |
| Δ | Agreed to deposit ticket |
| И | Footed |
| Φ | Agreed to voucher register |
| # | Agreed to cash balance in general ledger |

# THE EFFECT OF INFORMATION TECHNOLOGY ON THE AUDIT

## I. INTRODUCTION

*Information technology* (IT) encompasses automated means of originating, processing, storing, and communicating information. The use of information technology affects the manner in which transactions are initiated, recorded, processed, and reported. An entity's use of information technology affects both the evaluation of internal control and the procedures used to gather evidence. Note, however, that the audit objectives are the same in a computerized environment as they are in a manual environment.

## II. DIFFERENCES BETWEEN MANUAL AND COMPUTERIZED (IT) ENVIRONMENTS

### A. Segregation of Duties

1. In a computerized environment, transaction processing often results in a combination of functions that are normally separated in a manual environment.
2. The additional risk associated with this (possibly incompatible) concentration of functions may be mitigated by the implementation of compensating controls.

Control team
Operators
Programmer
Analyst (system)
Librarian

### B. Disappearing Audit Trail

1. Paper audit trails are substantially reduced in a computerized environment (particularly in on-line, real-time systems). If a client processes most of its financial data in electronic form, without any paper documentation, audit tests should be performed on a continuous basis.
2. Computer systems should be designed to supply electronic audit trails, which are often as effective as paper trails.
3. Use of IT may make it more difficult to use physical inspection to identify nonstandard or unusual transactions or adjustments.

### C. Uniform Transaction Processing

1. Processing consistency is improved in a computerized environment because clerical errors (e.g., random arithmetic errors, missed postings, etc.) are virtually eliminated.
2. In a computerized environment, however, there is an increased potential for systematic errors, such as errors in programming logic (e.g., using the incorrect tax rate).

### D. Computer-Initiated Transactions

1. Automated transactions are not subject to the same types of authorization as are used for manual transactions and may not be as well-documented.
2. When information is automatically transferred from transaction processing systems to financial reporting systems, inadvertent errors are reduced, but unauthorized interventions may not be evident.

### E. Potential for Increased Errors and Irregularities = Negative/disadvantages

Several characteristics of computerized processing act to increase the likelihood that fraud may occur and may remain undetected for long periods of time.

1. The opportunity for remote access to data in networked environments increases the likelihood of unauthorized access. Therefore, specific controls should exist to ensure that users can only access and update authorized data elements.
2. Concentration of information in computerized systems means that, if system security is breached, the potential for damage is much greater than in manual systems.
3. Decreased human involvement in transaction processing results in decreased opportunities for observation.
4. Errors or fraud may occur in the design or maintenance of application programs.
5. Computer disruptions may cause errors or delays in recording transactions.

**F. Potential for Increased Supervision and Review** = Positive/advantages

1. Computer systems provide more opportunities for data analysis and review, including integration of audit procedures in the application programs themselves.
2. Utilization of these opportunities can help mitigate the additional risks associated with a lack of segregation of duties.
3. In a computerized environment, the increased availability of raw data and management reports affords greater opportunity for both the client and the auditor to perform analytical procedures.

**G. Dependence on IT General Controls Over Computer Processing**

Controls for specific applications are only as effective as the general controls in place in the information technology department, which processes the transactions and produces the reports.

## III. EFFECT OF INFORMATION TECHNOLOGY ON EVIDENCE GATHERING

An auditor can use manual audit procedures (called "auditing around the computer"), computer-assisted audit techniques (CAAT, commonly called "auditing through the computer"), or a combination of both. In either event, because the reliability of automated systems is highly dependent on the adequacy of control design and execution, it is critical that the auditor gain a thorough understanding of the structure and usage of the control system through inquiry and observation.

**A. Factors to Consider**

In selecting the appropriate audit procedures in a computerized environment, the auditor should consider:

1. The extent of computer utilization in each accounting application,
2. The complexity of the entity's computer operations,
3. The organizational structure of the information technology department,
4. The availability of an audit trail, and
5. The use of computer-assisted audit techniques (covered below).

Note: Substantive testing alone may not suffice - test of controls should be performed to assess control risk (in highly computerized system)

## B. Use of an IT Professional

Because some systems depend so heavily on computerized processing, it may be difficult or impossible for the auditor to access certain information without assistance. If specialized IT skills are needed, the auditor should seek the help of an IT professional from his or her staff or from the outside.

1. The auditor should have enough IT-related knowledge to:
   a. Communicate audit objectives to the IT professional,
   b. Evaluate the sufficiency of the procedures performed, and
   c. Evaluate the results of the procedures performed.
2. The CPA's responsibility to guide IT professionals is the same as for other accounting specialists.
3. The auditor need not personally possess the required level of IT skills.

## C. Auditing Around the Computer = Manual audit procedures

1. When auditing around the computer, the auditor does not directly test the application program. The auditor tests the input data, processes the data independently, and then compares the independently determined results to the program results. Emphasis is on the input and output stages of transaction processing.
2. Auditing around the computer is often appropriate for simple batch systems with a good audit trail, and will result in the same level of confidence as would auditing through the computer.
3. Risks of auditing around the computer include insufficient, paper-based evidence and insufficient audit procedures.

## D. Computer Assisted Audit Techniques *(CAAT)* = Auditing through the computer

When using CAATs, emphasis is on the input and processing stages of transaction processing. In highly automated systems, complex audit trails and the elimination of physical source documents may mean that CAATs are the only feasible way to complete the audit in a timely manner. CAATs include:

### 1. Transaction Tagging

Transaction tagging is a technique the auditor uses to electronically mark (or "tag") specific transactions and follow them through the client's system.

   a. Tagging allows the auditor to test both the computerized processing and the manual handling of transactions.

### 2. Embedded Audit Modules

Embedded audit modules are sections of the application program code that collect transaction data for the auditor.

   a. For example, an auditor might want to examine all transactions affecting a specific account code that are greater than $500.

b. Embedded audit modules are most often built into the application program when the program is developed, for use in ensuring that controls are operating effectively.

3. **Test Data** *(test deck)*

Test data refers to a technique that uses the application program to process a set of test data, the results of which are already known. (The client's system is used to process the auditor's data, off-line, while still under the auditor's control.)

Examples
- Invalid #
- Excess pay rate
- Excess hours

a. The test data contains the types of invalid conditions in which the auditor is interested (it is not necessary to test all combinations of invalid conditions).

b. An advantage of the test data technique is that the live computer files are not affected in any way.

4. **Integrated Test Facility** *(ITF)*

An *integrated test facility* (ITF) is similar to the test data approach except that the test data is commingled with live data. (The client's system is used to process the auditor's data, on-line.)

a. The test data must be separated from the live data before the reports are created. This is usually accomplished by processing the test data to dummy accounts (e.g., a fictitious customer, branch, vendor, etc.).

b. Client personnel are not informed that the test is being run.

5. **Parallel Simulation** *(reperformance test)*

*Parallel simulation* (reperformance test) is a technique where the auditor reprocesses some or all of the client's live data (using software provided by the auditor) and then compares the results with the client's files. (The auditor's system is used to process the client's data.)

a. With controlled processing, the auditor observes an actual processing run and compares the actual results to the expected results (based on the auditor's program).

b. With controlled reprocessing, the auditor uses an archived copy of the program in question (generally the auditor's control copy) to reprocess transactions. The results are then compared to the results from the normal processing run. (Differences indicate that there have been changes to the program.)

(1) Source code comparison programs are programs that compare two versions of software to determine if they match. This type of software can be used to look for unauthorized program changes.

c. Programs to accomplish parallel processing can be specifically developed for the application, bought as a packaged program or utility, or produced by a generalized audit software package.

### E. Generalized Audit Software Packages *(GASPs)*

Generalized audit software packages (GASPs) allow the auditor to perform tests of controls and substantive tests directly on the client's system. The auditor first defines the client's system (to the GASP) and then specifies the tests and selections that should be made. The GASP generates the programs necessary to interrogate the files and extract and analyze the data.

**1. Tasks Typically Performed by GASPs**

a. Examining transactions for control compliance.

b. Selecting items meeting specified criteria.

c. Recalculating amounts and totals.

d. Reconciling data from two separate files.

e. Performing statistical analysis on transactions.

**2. Advantages of Using GASPs**

a. GASPs allow the auditor to sample and test a much higher percentage of transactions, which should result in a more reliable audit.

b. GASPs require little technical knowledge. (Client's hardware/software features)

c. After the initial use, GASPs can significantly reduce audit time without sacrificing quality.

## IV. AUDITING WITH A COMPUTER

An auditor may achieve audit efficiency by utilizing a computer during the audit. For example, financial statements (and related trial balances and lead schedules) may be entered into a spreadsheet (or possibly a database) program. Achieving efficiency requires the selection of both appropriate audit tasks and appropriate software for the selected tasks.

### A. Advantages of Using a Computer

1. Automatic performance of math on all documents, which reduces errors.

2. Automatic cross-referencing of amounts by linking each lead schedule to the working trial balance and to the financial statements. (This saves considerable time in posting adjusting journal entries.)

3. Automatic preparation of financial statements, tax return schedules, and consolidating schedules (all of which save time previously spent typing them, and which make late changes easier to implement).

4. Reduction in required supervisory review time.

   a. Computer printouts are more legible than most handwriting.

   b. Once the reliability of the software has been confirmed, less time is required to review and prove such things as footings, postings, ratio calculations, and cross references.

5. Automatic performance of certain analytical review procedures, such as:
   a. Computing account differences from one year to the next, and
   b. Computing the percentage increase or decrease in each account.
6. Enhanced client service—the client's personnel can benefit from:
   a. No longer needing to manually prepare schedules that are now permanently in the computer,
   b. More legible adjusting journal entry listings,
   c. Enhanced analytical information, and
   d. The ability to review a draft of the financial statements while the auditors are still in the field.
7. Improved morale and productivity for the audit team, as less time is spent on tedious clerical tasks (such as preparing lead schedules, endlessly posting columns of figures, etc.).

**B. Disadvantages of Using a Computer**

The primary disadvantage of auditing with a computer is that audit documentation may not contain readily observable details of calculations.

# GOVERNMENT AUDITING

## I. SOURCES OF GOVERNMENT AUDITING STANDARDS

GAAS and GAGAS are the sources of standards for governmental audits. Title 2 of the Code of Federal Regulations, 200.500–521 (containing single audit requirements), is a source of additional requirements for audits of federal financial assistance. Requirements are progressive, in that GAGAS includes all GAAS, and 2 CFR 200 single audit requirements anticipate the use of GAGAS.

### A. GAAS: Generally Accepted Auditing Standards

*Generally Accepted Auditing Standards* for the audits of nonissuers are issued by the AICPA's Auditing Standards Board (ASB) in the form of Statements on Auditing Standards (SAS). The ASB's Statements on Auditing Standards are outlined in Section AU-C of the AICPA Professional Standards and have been described previously. GAAS are applicable to all audits.

### B. GAGAS: Government Auditing Standards (Yellow Book)

*Generally Accepted Government Auditing Standards* (GAGAS) are organized as foundations and ethical principles, general standards, standards for financial audits and attestation engagements, and field work and reporting standards for performance audits. GAAS are incorporated by reference and additional standards applicable to government expand the auditors' requirements.

1. GAGAS contain standards for audits of:
   a. Government organizations, programs, activities, and functions.
   b. Government assistance received by contractors, not-for-profit organizations, and other nongovernmental organizations.
2. GAGAS includes designing the audit to provide reasonable assurance of detecting material misstatements resulting from noncompliance.

**PASS KEY**

GAGAS defines "unconditional requirements" with which the auditor "must" comply and "presumptively mandatory requirements" with which the auditor "should" comply. The reason for not observing presumptively mandatory requirements that are not observed must be documented.

### C. Audit Requirements for Federal Financial Assistance

Audits of recipients of federal financial assistance should be conducted in accordance with both GAAS and GAGAS. The following requirements also apply:

Requires Extra fieldwork and reporting standards

1. Expanded internal control documentation and testing requirements.
2. Expanded reporting to include formal written reports on the consideration of internal control and the assessment of control risk.
3. Expanded reporting to include whether the federal financial assistance has been administered in accordance with applicable laws and regulations (i.e., compliance requirements).
4. Application of single audit standards to federal financial assistance (covered later).

**PASS KEY**

The examiners focus on expanded audit and reporting requirements related to audits of organizations that receive government assistance, particularly federal financial assistance. Fact patterns often focus on either the additional requirements associated with GAGAS and 2 CFR 200 single audits or on the differences between government and commercial auditing.

Two types of audits
- Financial
- Performance

## II. PURPOSES AND TYPES OF GOVERNMENT AUDITS

### A. Financial Audits

#### 1. GAAP Basis Financial Statements

Financial statement audits performed according to *Government Auditing Standards* (the Yellow Book) incorporate GAAS and determine whether the financial statements present fairly the financial position, results of operations, and, where applicable, cash flows in accordance with generally accepted accounting principles.

#### 2. OCBOA Financial Statements

Engagements can also include audits of financial statements prepared in conformity with other comprehensive bases of accounting. Government regulators generally specify the OCBOA to be used in relation to financial assistance provided to organizations. Government audit standards can be used in connection with audits of nonissuers for audits otherwise conducted using AICPA standards, and audits of issuers otherwise conducted using PCAOB standards.

### B. Attestation Engagements

Attestation Engagements

Attestation engagements performed in conformity with *Government Auditing Standards* (the Yellow Book) incorporate the AICPA's standards for examinations, reviews, and agreed-upon procedures by reference and include expanded requirements. Subjects of attestation agreements could include:

1. Compliance with specified laws, regulations, rules, contracts, or grants.
2. Effectiveness of internal control over compliance with specified requirements (e.g., bidding, etc.).
3. Presentation of Management's Discussion and Analysis (MD&A).
4. Reliability of performance measures.

CPA determines if administrated in accordance with laws & regs.

### C. Performance Audits

Performance audits under GAGAS include a range of engagements with specific governing standards for three objectives described below. Some objectives may overlap with each other and with attestation engagements.

#### 1. Effectiveness, Economy, and Efficiency

a. Achievement of legislative, regulatory, or organizational goals.

b. Evaluation of cost benefit or cost effectiveness.

c. Validity or reliability of performance measures.

#### 2. Internal Control

a. Organizational missions, goals, and objectives are achieved efficiently and effectively.

b. Resources are used in compliance with laws, rules, and regulations.

c. Security over computerized systems is effective.

d. Disaster plans for computerized systems are adequate.

3. **Compliance**

   a. Compliance criteria established by laws, regulations, contract, etc., have been met.

   b. Appropriate target population has been served.

## III. EFFECTS OF LAWS AND REGULATIONS ON FINANCIAL STATEMENTS

Laws and regulations may have a direct and material effect on the determination of financial assistance revenue amounts displayed in financial statements. Laws and regulations may address the government as a whole (e.g., fund structure, required procurement, debt limitations, and legal authority for transactions) or address specific transactions or revenues (e.g., grant administration issues, such as degree of indirect costs, allowable costs under published cost principles, etc.).

### A. Increased Management Responsibilities Identified by GAGAS

**Management Responsibilities**

Laws and regulations applicable to the expanded accountability associated with government accounting increase management responsibilities to include the following:

1. Identification of applicable laws and regulations with compliance requirements.
2. Establishment of internal controls to provide reasonable assurance that the entity complies with those laws and regulations.
3. Preparation of supplementary financial reports, including a *Schedule of Expenditures of Federal Awards.*
4. Obtaining an audit that satisfies relevant legal, regulatory, or contractual requirements.

### B. Increased Auditor Responsibilities Identified by GAGAS

**Auditor Responsibilities**

Expanded accountability requirements associated with governmental accounting and reporting increase auditor responsibilities in the following ways:

1. Obtaining reasonable assurance that the financial statements are free of material misstatements resulting from violations of laws and regulations that have a direct and material effect on the determination of financial statement amounts.

   a. Auditors are not, however, required to provide reasonable assurance of detecting abuse since it is subjective.

   b. Abuse involves behavior that is deficient when compared to the behavior of a prudent person. It does not necessarily involve fraud, violations of laws or regulations, or violations of contract or grant provisions.

2. Assessing whether management has identified laws and regulations that have a direct and material effect on the determination of amounts in the entity's financial statements.
3. Obtaining an understanding of the possible effects on financial statements of the laws and regulations identified by management.
4. Obtaining an understanding of the possible effects on financial statements of laws and regulations that are generally recognized by auditors to have a direct and material effect on the determination of amounts in an entity's financial statements.

5. Communicating to management and those charged with governance that an audit in accordance with GAAS may not be sufficient if, during the course of that GAAS audit, the auditor becomes aware that the entity is subject to additional audit requirements that may not be encompassed in the terms of the engagement.

## IV. GAAS REQUIREMENTS FOR COMPLIANCE AUDITS

GAAS requirements for compliance audits are used in connection with GAGAS compliance auditing standards.

### A. Objectives of Compliance Audits

1. Obtain sufficient evidence to form an opinion on whether the entity complied, in all material respects, with the compliance requirements applicable to its programs.
2. Report at the level specified in the governmental audit requirement.
3. Identify audit and reporting requirements supplementary to GAAS and GAGAS and address those requirements (e.g., Single Audit Act requirements).

### B. Assumptions

GAAS requirements presume that management will:

1. Identify government programs and understand and comply with compliance requirements.
2. Maintain effective controls that provide reasonable assurance the entity will comply with compliance requirements.
3. Conduct ongoing evaluation and monitoring of compliance requirements.
4. Take appropriate corrective action on audit compliance findings.

### C. Overall Standards for Compliance Audits

1. Perform a risk assessment (audit risk of noncompliance model).
2. Design responses to the risk assessment.
3. Determine if supplementary audit requirements exist.
4. Obtain written representations from management.
5. Prepare reports.
6. Prepare required documentation.

### D. Audit Risk of Noncompliance Model

The audit risk of noncompliance model adapts the terminology and relationships of the audit risk model. It is comprised of the risk that material noncompliance exists and the risk that the auditor will not detect such noncompliance (detection risk):

| Audit Risk of Noncompliance (should be low) | = | Risk of Material Noncompliance (assessed by auditor) | × | Detection Risk (controlled by auditor) |
|---|---|---|---|---|

Inverse

- As risk of noncompliance increases ↑
- CPA should decrease ↓ detection risk = (More audit work)

1. **Risk of Material Noncompliance** = Client system

Just like RMM

The *risk of material noncompliance* is composed of two elements:

a. **Inherent Risk of Noncompliance**

The susceptibility of a compliance requirement to noncompliance that could be material, assuming that there are no related controls. Inherent risk exists independent of the audit. The *auditor cannot change* this risk, but *can* change his or her *assessment* of the risk based on evidence gathered during the audit.

b. **Control Risk of Noncompliance**

The risk that noncompliance with a compliance requirement that could be material will not be prevented or detected on a timely basis by an entity's internal control. Control risk exists independent of the audit. The *auditor cannot change* this risk, but *can* change his or her *assessment* of the risk based on evidence gathered during the audit.

(1) The stronger the system of controls over compliance, the greater the reliance that may be placed on the controls, and the fewer the tests of details (or the lower the quality of evidence) required.

Inverse

2. **Detection Risk of Noncompliance** = Auditor work

The risk that the auditor will not detect material noncompliance that exists. Detection risk relates to the auditor's procedures. The *auditor can change* this risk by varying the nature, extent, or timing of audit procedures.

a. As the acceptable level of detection risk decreases, the assurance provided by tests of details (including tests of implementation of corrective actions from previous audits) should increase.

**E. Design Responses to Risk Assessment**

1. The auditor must design audit procedures, including tests of details of the entity's compliance with program requirements.

   a. The auditor should consider if the risks of material noncompliance were due to fraud or error.

   b. The auditor should consider whether the risks of material noncompliance are pervasive (e.g., the risks impact many compliance requirements).

      (1) Pervasive risks require an overall response.

2. The risk assessment, tests of controls, and analytical procedures are not sufficient to address the risk of material noncompliance—tests of details are required.

   a. The auditor should perform further audit procedures to obtain the required evidence to support an opinion on compliance.

3. Tests of the operating effectiveness of controls may be required if any one of the following conditions exists:

   a. The risk assessment includes an expectation of the operating effectiveness of controls over compliance.

   b. Substantive procedures do not provide enough evidence to support a conclusion.

   c. Tests of controls are required by the applicable governmental audit requirements.

4. Results of tests of controls:

   a. Deficiency in internal control over compliance:

      (1) Design weaknesses result in controls that would not detect noncompliance.

      (2) Operating weaknesses result in ineffective compliance monitoring from poor execution (individuals lack competence or authority to properly execute controls).

   b. Material weaknesses in internal control over compliance exist when it is reasonably possible that noncompliance will go undetected.

**F. Determine if Supplementary Audit Requirements Exist**

1. The entity may have audit requirements that go beyond GAAS and GAGAS. The auditor must make that determination.

2. A common example of supplementary audit requirements is the Single Audit requirements related to federal financial assistance described below.

**G. Obtain a Written Management Representation Letter** = Required

Auditors must obtain a written management representation letter, which includes the following statements:

1. Management takes responsibility for understanding and fulfilling compliance requirements.

2. Management takes responsibility for maintaining controls over compliance.

3. Management asserts it has disclosed all of the programs to the auditor.

4. Management has made all contracts, grant agreements, and other relevant documents available to the auditor.

5. Management has disclosed any known noncompliance, or has stated no such noncompliance exists.

6. Management believes the entity has complied with requirements.

7. Management identifies and interprets any applicable compliance requirements that might be subject to varying interpretations.

8. Management has disclosed any communications from grantors.

9. Any events occurring between the balance sheet date and the last date of the report have been disclosed.

10. Management is responsible for correcting noncompliance.

## H. Prepare Reports

The auditor may prepare a report several different ways depending on the audit requirement. Possible reports include a(n):

1. Opinion on compliance.
2. Report on internal control over compliance.
3. Combined report on compliance and internal control over compliance.
4. **Sample—*Combined Report on Compliance With Applicable Requirements and Internal Control Over Compliance***

**Independent Auditor's Report**

[*Addressee*]

Compliance

We have audited Example Entity's compliance with the [*identify the applicable compliance requirements or refer to the document that describes the applicable compliance requirements*] applicable to Example Entity's [*identify the government program(s) audited or refer to a separate schedule that identifies the program(s)*] for the year ended June 30, 20XX. Compliance with the requirements referred to above is the responsibility of Example Entity's management. Our responsibility is to express an opinion on Example Entity's compliance based on our audit.

Report on the scope of testing IC

We conducted our audit of compliance in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in Government Auditing Standards issued by the Comptroller General of the United States; and [*insert the name of the governmental audit requirement or program-specific audit guide*]. Those standards and [*insert the name of the governmental audit requirement or program-specific audit guide*] require that we plan and perform the audit to obtain reasonable assurance about whether noncompliance with the compliance requirements referred to above that could have a material effect on [*identify the government program(s) audited or refer to a separate schedule that identifies the program(s)*]. An audit includes examining, on a test basis, evidence that Example Entity's compliance with those requirements and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion. Our audit does not provide a legal determination of Example Entity's compliance with those requirements.

In our opinion, Example Entity complied, in all material respects, with the compliance requirements referred to above that are applicable to [*identify the government program(s) audited*] for the year ended June 30, 20XX.

(continued)

(continued)

Internal Control Over Compliance

Management of Example Entity is responsible for establishing and maintaining effective internal control over compliance with the compliance requirements referred to above. In planning and performing our audit, we considered Example Entity's internal control over compliance to determine the auditing procedures for the purpose of expressing our opinion on compliance, but not for the purpose of expressing an opinion on the effectiveness of internal control over compliance. Accordingly, we do not express an opinion on the effectiveness of Example Entity's internal control over compliance.

A deficiency in internal control over compliance exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, noncompliance on a timely basis. A material weakness in internal control over compliance is a deficiency, or combination of deficiencies in internal control over compliance, such that there is a reasonable possibility that material noncompliance with a compliance requirement will not be prevented, or detected and corrected, on a timely basis.

Limitation on testing

Our consideration of internal control over compliance was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control that might be deficiencies, significant deficiencies, or material weaknesses in internal controls over compliance. We did not identify any deficiencies in internal control over compliance that we consider to be material weaknesses, as defined above.

This report is intended solely for the information and use of management, [*identify the body or individuals charged with governance*], others within the entity, [*identify the legislative or regulatory body*], and [*identify the grantor agency(ies)*] and is not intended to be and should not be used by anyone other than these specified parties. Restrict use

[Signature]

[Date]

## I. Documentation

Required documentation includes the following:

1. The assessed risk of material noncompliance, including:
   a. The procedures performed.
   b. Documentation of internal control (narratives, flowcharts, etc.).
2. Responses to the risk assessment, including:
   a. Procedures to test compliance and results of procedures.
   b. Tests of controls.
3. The basis or rationale for materiality levels.
4. Compliance with supplemental requirements.

## V. GOVERNMENT AUDITING STANDARDS (GAGAS)

Generally Accepted Government Auditing Standards (GAGAS) include the following ethical principles, general standards, and standards for financial audits.

### A. Ethics

The ethical principles of GAGAS provide the foundation that influences the application of GAGAS. The ethical principles that guide the work of auditors who conduct audits in accordance with GAGAS are serving the public interest, integrity, objectivity, proper use of governmental information, resources and positions, and professional behavior.

#### 1. Serving the Public Interest

The public interest is defined as the collective well-being of the community of people and entities served by the auditor.

#### 2. Integrity

Integrity includes auditors conducting their work with an attitude that is objective, fact-based, nonpartisan, and nonideological with regard to the audited entities and users of the auditors' reports.

#### 3. Objectivity

Objectivity includes independence of mind and appearance when providing audits, maintaining an attitude of impartiality, having intellectual honesty, and being free of conflicts of interest.

#### 4. Proper Use of Government Information, Resources, and Positions

The auditor is to use government information, resources, and positions for official purposes and not inappropriately for the auditor's personal gain.

#### 5. Professional Behavior

Professional behavior includes an auditor's honest effort in the performance of professional services in accordance with the relevant technical and professional standards. The auditor must avoid any conduct that might bring discredit to the auditor's work, including actions that would cause an objective third party to conclude that the auditor's work was professionally deficient.

### B. General Standards

The general standards provide guidance for performing financial audits, attestation engagements, and performance audits under GAGAS. The general standards address independence, professional judgment, competence, and quality control and assurance.

#### 1. Independence

Independence includes the concepts of independence of mind and appearance. GAGAS provides a conceptual framework (described in greater detail below) to evaluate and respond to threats to independence.

##### a. Independence of Mind

An auditor's state of mind should permit the performance of an audit without being affected by influences that compromise professional judgment.

##### b. Independence in Appearance

Auditors should avoid circumstances that would cause a reasonable third party to conclude that independence has been compromised.

2. **Professional Judgment**

Auditors must use professional judgment in planning and performing audits and in reporting the results. Professional judgment includes exercising reasonable care and professional skepticism.

3. **Competence**

The staff assigned to conduct the audit in accordance with GAGAS must collectively possess:

a. The adequate professional competence needed to address the audit objectives and perform the work in accordance with GAGAS.

b. The technical knowledge, skills, and experience necessary to be competent for the type of work being performed before beginning work on the audit.

4. **Quality Control and Assurance** = Peer review every 3 years

Each audit organization performing audits in accordance with GAGAS must:

a. Establish and maintain a system of quality control that is designed to provide the audit organization with reasonable assurance that the organization and its personnel comply with professional standards and applicable legal and regulatory requirements.

b. Have an external peer review at least once every three years.

C. **Standards for Financial Audits: Additional GAGAS Requirements for Performing Financial Audits**

GAGAS includes a number of requirements for financial audits in addition to the standard GAAS requirements.

1. **Previous Audits and Attestation Engagements**

The auditor should evaluate whether appropriate corrective actions to address findings and recommendations from previous audit and attestation engagements have been addressed. Planning procedures should include inquiry of management about the status of previous audits and recommendations. Management's response should be included in the auditor's risk evaluation.

2. **Fraud, Noncompliance, and Abuse**

Audits in accordance with GAGAS require additional attention to fraud, noncompliance with laws and regulations, and abuse. The auditor should:

a. Consider compliance with contracts or grant agreements in addition to laws and regulations.

b. Consider the occurrence of abuse:

(1) Abuse involves deficient or improper behavior, including the misuse of authority or position for gain. It does not necessarily involve fraud or noncompliance

(2) Auditors are not required to detect abuse because abuse is subjective.

(3) Awareness of abuse that is quantitatively or qualitatively material to the audit obligates the auditor to perform further testing.

c. Auditors should avoid interference with investigations or legal proceedings when pursuing indications of fraud or noncompliance.

3. **Developing a Finding**

GAGAS defines the specific requirements associated with developing a finding to be reported to both the audited entity and others. Auditors should plan and perform procedures to develop the elements of a finding that are relevant and necessary to achieve audit objectives. The elements of a finding include criteria, conditions, cause, and effect or potential effect.

a. **Criteria**

Criteria define expectations of a program or operation. Criteria are often laws, regulations, contracts, or grant agreements. Criteria may also be standards or benchmarks.

b. **Condition**

The condition is the situation or status that exists.

c. **Cause**

The cause is the reason for the condition or the deviation from the criteria. Examples include poorly designed policies, inconsistent implementation of policies, etc.

d. **Effect or Potential Effect**

The effect or potential effect is a clear logical link between the condition and the deviation from criteria. It describes the outcomes or consequences of the condition. Effect demonstrates the need for corrective action.

4. **Audit Documentation**

a. Under GAGAS, auditors also should document, before the audit report is issued, evidence of supervisory review of the work performed that supports findings, conclusions, and recommendations contained in the audit report.

b. Auditors should also document departures from GAGAS and the impact on the audit due to noncompliance caused by law, regulation, scope limitations, etc.

D. **Standards for Financial Audits: Additional GAGAS Requirements for Reporting on Financial Audits**

1. **Auditor's Compliance With GAGAS**

Auditors should include a statement in the auditors' report that they complied with GAGAS.

2. **Report on Internal Control and Compliance With Provisions of Laws, Regulations, Contracts and Grant Agreements**

Auditors should include in the same or separate reports a description of the scope of the auditors' testing of internal control over financial reporting and compliance with laws, regulations, contracts and grant agreements. Auditors should state whether the tests the auditor performed provide sufficient appropriate evidence to support an opinion on the effectiveness of internal control over compliance.

a. Reports should be made regardless of whether there are internal control deficiencies.

b. The objective of the GAGAS requirement for reporting on internal control over financial reporting differs from the objective of an examination of internal control in accordance with AICPA standards.

(1) GAGAS only requires a report on internal control and compliance that describes the scope of the auditor's testing and any findings. However, the auditor may elect to increase testing to a level that provides sufficient appropriate evidence to support an opinion on the effectiveness of internal control over compliance.

(2) In an examination of internal control in accordance with AICPA standards, the standards require the auditor to provide a high level of assurance about internal control over financial reporting in the form of an opinion.

c. The report on financial statements should reference the existence of a separate report on internal control and compliance if separate reports are used.

**3. Communicate Deficiencies in Internal Control, Fraud, and Noncompliance**

**a. Deficiencies in Internal Control**

The AICPA's requirement for written reports on significant deficiencies forms the basis for reporting. See the Auditing 5 lecture.

**b. Instances of Fraud and Noncompliance**

The auditor should report to the appropriate members of the audited organization:

(1) Fraud and noncompliance with laws or regulations that have a material effect on the financial statements;

(2) Noncompliance with provisions of contracts or grant agreements that have a material effect on the financial statements; and

(3) Abuse that is material either quantitatively or qualitatively. Examples of abuse include creating unneeded overtime, requesting staff to perform personal errands for a supervisor or manager, making expensive or extravagant travel arrangements, and making vendor selections contrary to policy.

**c. Less Than Material Findings**

Less than material findings should be communicated to appropriate officials.

**d. Presenting Findings in the Auditors' Reports**

A listing of findings and management responses is included in the report on internal control and compliance, or may be separately presented in a schedule of findings. The presentation of findings should:

(1) Comply with the guidance for elements of a finding.

(2) Be placed in perspective by describing the nature and extent of the issues reported and the extent of the work performed.

**e. Reporting Findings to Outside Parties**

Findings may be communicated to parties outside the audited organization when management fails to:

(1) Satisfy legal or regulatory requirements to report.

(2) Take time and appropriate steps to respond to known or likely fraud, noncompliance, or abuse.

4. **Report Views of Responsible Officials**

Auditors must report their findings and also solicit and report the views of responsible officials along with any planned corrective actions. Providing a draft report with findings to appropriate members of the audited organization promotes the development of fair, complete, and objective reports. Responses of the audited organization should be in writing, but oral comments are acceptable.

a. Written responses by the audited organization are included in the auditor's report.

b. Oral responses will be confirmed in writing by the auditor, but not published in the report.

c. Responses from the audited organization that either contradict or fail to fully address the auditor's comments should prompt the following actions:

(1) Evaluate the validity of the audited organization's comments; and

(2) Explain the basis for the disagreement in the report or modify the comment.

d. Auditors may issue their reports without responses if the audited entity refuses to make comments or is unable to make comments. The audit report should disclose that the audited entity did not provide comments.

5. **Reporting Confidential or Sensitive Information**

a. Audit reports should disclose the exclusion of confidential or sensitive information from an audit report by:

(1) Reporting the omission of information, and

(2) Stating the reason or other circumstances that made the omission necessary.

b. Auditors may issue separate, classified, or limited use reports that are distributed to only the persons authorized by law or regulation to receive the confidential information.

c. Auditors should evaluate whether the omission of confidential or sensitive information could distort audit results or conceal improper or illegal practices.

6. **Distribute Reports**

a. Audit organizations should distribute auditor's reports to:

(1) Those charged with governance;

(2) Audited entity officials;

(3) Oversight bodies or those who require or arrange for the audits;

(4) Officials with oversight authority or who may be responsible for acting on audit findings and recommendations; and

(5) All others authorized to receive reports.

b. Internal audit organizations in government entities must follow Institute of Internal Auditors (IIA) International Standards for the Professional Practice of Internal Auditing.

(1) The head of the internal audit organization must consider the risks to the audited organization prior to release of reports outside of the organization.

(2) The head of the internal audit organization should consult with senior management and control dissemination of reports to intended users.

c. Independent external auditors should clarify report distribution responsibilities with the party contracting for the audit.

d. Auditors should document any limitation on report distribution.

**7. Additional GAGAS Considerations for Financial Audits**

**a. Materiality Thresholds**

GAGAS auditors should consider reducing materiality thresholds in response to:

(1) Public accountability issues;

(2) Various legal and regulatory requirements; and

(3) Visibility and sensitivity of government programs.

**b. Early Communication of Deficiencies**

Deficiencies may be reported early when:

(1) Urgency or significance of findings may require faster corrective actions or follow-up.

(2) Ongoing noncompliance undetected by management should be stopped.

## E. Written Representations from Management *(GAGAS)*

1. GAAS guidance with respect to client representations should be followed.

2. The following representations, consistent with or in addition to GAAS, should be included:

a. There are no violations or possible violations of laws or regulations whose effects should be considered for disclosure in the financial statements or as a basis for recording a loss contingency (same as GAAS).

b. Management is responsible for the entity's compliance with laws and regulations applicable to it.

c. Management has identified and disclosed in writing to the auditor all the laws and regulations that have a direct and material effect on its financial statements.

## F. Opinion on Financial Statements and Supplementary Schedule of Expenditures of Federal Awards

The required features of an opinion on financial statements and supplementary schedule of federal awards prepared in accordance with GAAS and GAGAS would include the following:

**1. Introductory Paragraph**

a. States the name of the entity, the financial statements audited, the balance sheet date, and the period under audit.

b. States management is responsible for preparing the financial statements and the auditor is responsible for auditing the financial statements.

**2. Scope Paragraph**

a. States the audit was performed in accordance with both GAAS and GAGAS.

b. Confirms both GAAS and GAGAS require tests to provide reasonable assurance the financial statements are free from material misstatement, and describes the character of audit procedures and assessments.

c. Asserts the audit provides a reasonable basis for the opinion.

3. **Opinion Paragraph**

   Expresses an opinion as to the fair presentation of the financial statements in conformity with generally accepted accounting principles.

4. **Disclosure Paragraph Regarding Additional Reports for GAGAS**

   States the auditor has complied with GAGAS and has issued a report on internal control over financial reporting and on the tests of the audited entity's compliance with laws, regulations, contracts, and grants.

5. **Opinion on Additional Schedules Required by the Single Audit Act**

   a. States the Schedule of Expenditures of Federal Awards is presented as a requirement of 2 CFR 200 single audit requirements and it is *not* a part of the basic financial statements.

   b. States the information was audited as part of the procedures applied to the basic financial statements.

   c. States whether the schedule is fairly stated in relation to the basic financial statements taken as a whole.

## G. Reporting: Fraud and Illegal Acts

The auditor should report all instances of fraud and illegal acts, unless inconsequential, and violations of provisions of contracts or grant agreements and abuse that could have a material effect in the financial statements.

1. **GAGAS Reporting Requirements Are Consistent With GAAS**

   Auditors should report the same information regarding fraud and illegal acts under GAGAS as they would report to an audit committee under GAAS.

   a. The auditor should report his or her conclusion that fraud or an illegal act has occurred, or is likely to have occurred.

   b. Clearly inconsequential information need not be reported.

2. **Reporting Illegal Acts Is Required**

   The auditor is required to report all illegal acts or possible illegal acts (i.e., acts that could result in criminal prosecution) to any one of the following:

   - The officials of the audited entity (top employees)
   - Those charged with governance (the board)
   - External regulators (generally the grantor)

   a. The reports may be:

      (1) Included in the required audit reports, or

      (2) Presented as separate audit reports.

   b. The auditor is required to directly report fraud and illegal acts discovered during the audit to the federal inspector general if:

      (1) Management fails to disclose such fraud or illegal acts to the grantor, or

      (2) Management fails to take appropriate remedial action.

**H. Reporting: Internal Control** Under GAGAS

The auditor should report all significant deficiencies and material weaknesses in internal control.

Report all fraud & illegal acts

1. GAGAS (like GAAS) requires the auditor to:
   a. Obtain an understanding of the design of relevant controls and determine whether they have been implemented.
   b. Communicate all significant deficiencies (reportable conditions) noted during the audit, even those that are not material weaknesses.
2. * GAGAS requires a written report on the auditor's understanding of internal control and the assessment of control risk in all audits. This is different from GAAS, which requires written communication only when significant deficiencies (reportable conditions) are noted.
3. Significant deficiencies should be reported to specific legislative and regulatory bodies.

**PASS KEY**

One of the most tested features related to government audits is the requirement that a written report on internal control be prepared. The content of that report is also frequently tested, and it includes:

CPA Exam tests

- 1 The assertion that evaluating compliance with laws, rules, and regulations with a direct and material effect on the financial statements is part of developing an opinion on financial statements.
- 2 The assertion that specific controls relating to financial reporting are considered.
- 3 An indication either no weaknesses were found or that significant deficiencies (reportable conditions) were found, and an indication whether those deficiencies were material.

## VI. GAGAS CONCEPTUAL FRAMEWORK FOR INDEPENDENCE

### A. Introduction

GAGAS independence guidance includes a conceptual framework for making independence determinations. The conceptual framework requires that the auditor:

1. Identify threats to independence;
2. Evaluate the significance of the threats identified, both individually and in the aggregate; and
3. Apply safeguards as necessary to eliminate the threats or reduce them to an acceptable level.

If no safeguards are available to eliminate an unacceptable threat or reduce it to an acceptable level, independence would be considered to be impaired.

### B. Threats to Independence

The following broad categories of threats to independence are identified by GAGAS:

**1. Self-Interest Threat** = Financial $ interest

Self-interest threat is the threat that a financial or other interest will inappropriately influence an auditor's judgment or behavior.

2. **Self-Review Threat** = We did non-audit services

   Self-review threat is the threat that an auditor or audit organization that has provided non-audit services will not appropriately evaluate the results of previous judgments made or services performed as part of the non-audit services when forming a judgment significant to an audit.

3. **Bias Threat** = CPA strong opinions

   Bias threat is the threat that an auditor will, as a result of political, ideological, social, or other convictions, take a position that is not objective.

4. **Familiarity Threat** = Long-term client (lack professional skepticism)

   Familiarity threat is the threat that aspects of a relationship with management or personnel of an audited entity, such as a close or long relationship, or that of an immediate or close family member, will lead an auditor to take a position that is not objective.

5. **Undue Influence Threat** = Pressure

   Undue influence threat is the threat that external influences or pressures will impact an auditor's ability to make independent and objective judgments.

6. **Management Participation Threat** = CPA acts for mgt.

   Management participation threat is the threat that results from an auditor's taking on the role of management or otherwise performing management functions on behalf of the entity undergoing an audit.

7. **Structural Threat** = Organization structure

   Structural threat is the threat that an audit organization's placement within a government entity, in combination with the structure of the government entity being audited, will impact the audit organization's ability to perform work and report results objectively.

**C. Safeguards**

Safeguards are controls designed to eliminate or reduce to an acceptable level threats to independence. Under the conceptual framework, the auditor applies safeguards that address the specific facts and circumstances under which threats to independence exist. In some cases, multiple safeguards may be necessary to address a threat. Examples of safeguards include:

1. Consulting an independent third party, such as a professional organization, a professional regulatory body, or another auditor;
2. Involving another audit organization to perform or reperform part of the audit;
3. Having a professional staff member who was not a member of the audit team review the work performed; and
4. Removing an individual from an audit team when that individual's financial or other interests or relationships pose a threat to independence.

**D. Evaluation of Non-audit Services**

The auditor should determine whether providing such a non-audit service would create a threat to independence, either by itself or in aggregate with other non-audit services provided, with respect to any GAGAS audit it performs.

1. A critical component of this determination is consideration of management's ability to effectively oversee the non-audit service to be performed.

a. The auditor should determine:

(1) That the audited entity has designated an individual who possesses suitable skill, knowledge, or experience; and

(2) That the individual understands the services to be performed sufficiently to oversee them.

b. The individual is not required to possess the expertise to perform or reperform the services.

c. The auditor should document consideration of management's ability to effectively oversee non-audit services to be performed.

2. Auditors performing non-audit services for entities for which they perform audits should obtain assurance that audited entity management performs the following functions in connection with the non-audit services:

a. Assumes all management responsibilities;

b. Oversees the services, by designating an individual, preferably within senior management, who possesses suitable skill, knowledge, or experience;

c. Evaluates the adequacy and results of the services performed; and

d. Accepts responsibility for the results of the services.

## E. Management Participation Threat

If an auditor were to assume management responsibilities for an audited entity, the management participation threat created would be so significant that no safeguards could reduce the threat to an acceptable level.

1. Management responsibilities involve leading and directing an entity, including making decisions regarding the acquisition, deployment and control of human, financial, physical, and intangible resources.

2. Whether an activity is a management responsibility depends on the facts and circumstances. The auditor exercises professional judgment in identifying these activities.

3. Examples of activities that are considered management responsibilities and would therefore impair independence if performed for an audited entity include:

a. Setting policies and strategic direction for the audited entity;

b. Directing and accepting responsibility for the actions of the audited entity's employees in the performance of their routine, recurring activities; and

c. Having custody of an audited entity's assets.

## F. Documentation of Independence

The independence standards require the auditor to document:

1. Threats to independence that require the application of safeguards, along with the safeguards applied, in accordance with the conceptual framework for independence.

2. The safeguards if an audit organization is structurally located within a government entity and is considered independent based on those safeguards.

3. Consideration of audited entity management's ability to effectively oversee a non-audit service to be provided by the auditor.

4. The auditor's understanding with an audited entity for which the auditor will perform a non-audit service.

## VII. SINGLE AUDITS: TITLE 2 OF THE CODE OF FEDERAL REGULATIONS, 200.500–521

### A. Responsibilities Under the Single Audit Act

#### 1. Entities Subject to the Single Audit Act

The *Single Audit Act* is governed by provisions of federal regulations in 2 CFR 200.500–521, part of regulations included in what is commonly known as the "Super Circular." It requires entities that expend total federal assistance equal to or in excess of $750,000 in a fiscal year to have an audit performed in accordance with the act.

a. The act allows for either a single or program-specific audit. The program-specific audit election is only available to certain grant recipients who meet highly restrictive criteria, including:

(1) Awards are expended under a single federal program.

(2) No financial statement audit is required.

b. Nonfederal entities that expend less than $750,000 a year in federal awards are exempt from federal audit requirements for that year.

#### 2. Objectives of the Single Audit

Single Audit Objectives

A single audit has two main objectives:

a. Audit of the entity's financial statements and reporting on a separate schedule of expenditures of federal awards in relation to those financial statements.

b. Compliance audit of federal awards expended during the year as a basis for issuing additional reports on compliance related to major programs and on internal control over compliance.

#### 3. Materiality Determinations

The Single Audit Act requires that the materiality of the transaction or other compliance finding be considered separately in relation to each major program, not simply in relation to the financial statements taken as a whole.

a. Major programs are determined in accordance with formulas prescribed by 2 CFR 200 single audit requirements. Generally, programs classified as major are those that expend $750,000 or more in federal financial assistance, but smaller programs may be deemed major if they are classified as "high risk," even if they do not meet the monetary threshold. The Circular provides guidance on applying this "risk-based approach" to program selection.

**PASS KEY**

The *audit threshold* for federal audit requirements is *expenditure of $750,000* of federal financial assistance.

*Single audits* are *generally required* unless the restrictive requirements of a program-specific audit are met.

*Program-specific audits* are used when the expenditures are made under only *one program* and the terms of the award *do not require a financial statement audit*.

b. Under both GAAS and GAGAS, materiality is considered in relation to the financial statements being audited taken as a whole.

**PASS KEY**

Remember, a single audit includes a separate evaluation of materiality for each major program selected.

4. **Audit Requirements Apply to Recipients and Subrecipients**

   Audit requirements apply to recipients and subrecipients of federal financial assistance. Contractors have more limited requirements.

> **PASS KEY**
>
> *Federal award recipients* (e.g., a city expending funds received directly from the U.S. Department of Housing and Urban Development) or a *subrecipient* (e.g., a city expending funds received from a state that received the funds from the U.S. Department of Housing and Urban Development) are subject to audit requirements associated with federal financial assistance.
>
> *Contractors* (e.g., those who are paid by recipients or subrecipients of federal financial assistance, such as an electrician performing service upgrades to a public housing authority) are not subject to the same audit requirements as recipients and subrecipients.

## B. Program-Specific Audits

1. Under certain circumstances, recipients are permitted to have a program-specific audit instead of a single audit.
2. Entities not covered by the Single Audit Act are also eligible.
3. The auditor must contact the Inspector General of the applicable federal agency and obtain a current program-specific audit guide.
4. The auditor must follow GAGAS and the guide when performing a program-specific audit.
5. If a program-specific audit guide is not available, the auditor has basically the same responsibilities as in an audit of a major program for a single audit.

> **PASS KEY**
>
> All governmental audits carried out under the Single Audit Act are not the same:
>
> - Audits of an entire organization that include additional audit procedures on specific programs are called "single audits." These audits include a report on the financial statements of the whole organization and audit reports on the specific programs.
> - Audits of specific programs are called "program-specific audits" and do not include reports on the financial statements of the organization taken as a whole.

## C. Auditee Responsibilities—*Auditor Selection*

1. Auditors must be selected using procurement standards established by federal guidelines.
2. Procurement standards preclude limitations on competition, including:
   a. the use of a single or sole source vendor (only considering one firm).
   b. providing preferences to local firms (giving advantages to firms based on geographic location).
3. Auditees must request a copy of the audit organization's peer review report.
4. Proposals made by auditors must be evaluated for:
   a. responsiveness to the request for proposal.
   b. relevant experience.
   c. the availability of professionally qualified staff.
   d. the results of peer reviews.

5. The use of small and minority-owned businesses is encouraged.

6. Consultants engaged to develop indirect cost plans may not be engaged as the auditor when the indirect costs recovered by the auditee during the prior year exceed $1 million.

> **PASS KEY**
>
> Auditor selection is made by the auditee, subject to federal guidelines that seek to ensure the appointment of an auditor possessing the necessary expertise through an open and competitive proposal process.

## D. Auditee Responsibilities—*Report Submission*

1. The audit report must be submitted:
   a. within 30 calendar days of receipt.
   b. within nine months after the end of the audit period.

2. Copies must be made available for public inspection (unless restricted by federal statute or regulation).

3. The audit report must be submitted in the following format:
   a. The report must be transmitted using a data collection form that follows a specific data set required by the OMB.
   b. The form must be signed by a responsible official.
   c. The reporting package must include:
      (1) Financial statements
      (2) A summary schedule of prior audit findings
      (3) Auditor's reports
      (4) Corrective action plans
   d. The report must be submitted electronically.

4. Reports must be retained for three years from the date of submission.

> **PASS KEY**
>
> The organization subject to audit is responsible for the production of financial statements and a schedule of federal expenditures, along with corrective actions, in response to audit findings. Auditee reports, along with auditor reports and findings, must be submitted by the auditee within 30 days of receipt or nine months after the end of the audit period.

## E. Auditor Responsibilities—*The Scope of the Audit*

**1. Financial Statements and Schedules**

The auditor should express an opinion regarding the fair presentation.

**2. Internal Control**

a. The auditor should consider internal controls over compliance using major programs as a basis for both testing and reporting.

b. Internal control guidance is taken from both the U.S. Office of the Comptroller General and the Committee of Sponsoring Organizations (COSO) Internal Control Framework.

c. The audit must be planned to support a low assessed level of control risk of noncompliance for major programs.

GR:

d. The auditor must plan and perform tests of controls over compliance for major programs.

Effective controls → Test

(1) The auditor is not required to test controls that are ineffective.

Ineffective controls → Report

(2) Significant deficiencies and material weaknesses must be reported.

(3) When controls are deemed ineffective, additional tests of compliance must be considered.

e. Auditors have no responsibility to obtain an understanding of internal control over compliance or perform related tests of compliance for any federal program deemed to be nonmajor.

**3. Compliance**

a. The auditor should express an opinion regarding major program compliance with statutes, regulations, and terms and conditions of the related federal award.

b. Compliance requirements are typically found in the compliance supplement. Otherwise, the auditor should look to the sources of compliance requirements (e.g., laws, regulations, or terms and conditions of the award).

**4. Previous Audit Findings**

The auditor is required to follow up on audit findings from previous audits.

**F. Auditor Responsibilities—*Audit Reporting***

The auditor should:

Express opinion

1. Express an opinion regarding the fair presentation of the financial statements, in accordance with GAAP.
2. Express an opinion regarding the fair presentation of the Schedule of Expenditures of Federal Awards (SEFA) in relation to the financial statements.
3. Report on internal control over financial reporting and compliance with federal statutes, regulations, and the terms and conditions for the federal award, including:
   a. the scope of testing of internal control over compliance.
   b. the results of tests.
   c. reference to a separate Schedule of Findings and Questioned Costs.
4. Report on compliance for each major program and report on internal control over compliance including:
   a. the scope of testing of internal control over compliance.
   b. an opinion with regard to compliance with federal statues, regulations and the terms and conditions of the federal award.
      (1) For reportable instances of noncompliance with the requirements governing a major federal financial assistance program, reports should be qualified ("except for") or adverse, depending on materiality.
      (2) Immaterial instances of noncompliance should be reported, but need not be specifically identified.
   c. reference to a separate Schedule of Findings and Questioned Costs.

5. Provide a schedule of findings that includes:

   a. A summary of the auditor's results:

      (1) The type of report issued by the auditor over the financial statements

      (2) Discovery of significant deficiencies or material weaknesses

      (3) Discovery of any material noncompliance

      (4) The type of report the auditor issued on compliance for major programs

      (5) A statement regarding whether the audit disclosed any audit findings the auditor is required to report

      (6) Identification of the major programs (a list of the major programs)

      (7) The dollar threshold used to distinguish between type A and type B programs

      (8) A statement as to whether the auditee qualified as a low-risk auditee

   b. GAGAS findings.

   c. Findings and questioned costs for federal awards.

## G. Auditor Responsibilities—*Audit Findings*

1. The auditor must report significant deficiencies and material weaknesses in internal control over major programs and significant instances of abuse related to major programs.

2. The auditor must report material noncompliance with provisions of federal statutes, regulations, or the terms and conditions of federal awards related to major programs.

3. The auditor must report questioned costs of a given type of compliance requirement if those costs exceed $25,000.

| EXAMPLE |
|---|
| An auditor is performing compliance testing on a rental assistance program, a major program administered by a federally funded public housing authority. A compliance requirement for this major program is that tenants must meet eligibility requirements, including income limitations. The auditor finds that a number of tenants for whom rent subsidies have been claimed earned income in excess of the tenant income limitations. The auditor accumulates the amounts associated with the noncompliance and questions $36,000 of the public housing authority's rent subsidies. Because the questioned costs are greater than $25,000, the auditor is required to report them. |

4. Findings must be stated clearly and in a manner that defines the deficiency and the implications of the deficiency.

## H. Auditor Responsibilities—*Audit Documentation*

1. Audit documentation must be maintained for three years after the date of issuance.

2. Contested audit findings or requests by the awarding or cognizant agency may extend the retention period. The cognizant agency is generally the lead agency that provides the most funding to the recipient and the one that receives and distributes the reports.

| PASS KEY |
|---|
| Both the auditor and the auditee must retain audit documentation for three years after issuance and receipt. |

## I. Auditor Responsibilities—*Major Program Determination*

### 1. Risk-Based Approach

a. The determination of major programs uses a risk-based approach.

b. The risk-based approach includes the consideration of:

(1) Current and prior audit experience

(2) Oversight by federal agencies

(3) Inherent risk

### 2. A Four-Step Process

| | |
|---|---|
| Step 1 | Identify type A ($750,000 or more) and type B programs (those not meeting the requirements of type A). |
| Step 2 | Identify type A programs that are low risk. |
| Step 3 | Identify type B programs that are high risk, using professional judgment. |
| Step 4 | At a minimum, major programs include all type A programs not identified as low risk and all type B programs identified as high risk that meet the coverage requirements described below. |

### 3. Percentage of Coverage

a. For low-risk auditees, the auditor must test 20 percent of the total federal awards expended.

b. For other auditees, the auditor must test 40 percent of the total federal awards expended.

### 4. Documentation

a. Audit workpapers should include documentation of the risk analysis defined in the federal guidance.

b. Major programs determined in accordance with federal guidance will not be challenged by federal agencies.

**PASS KEY**

Auditors select major programs for audit using a risk-based approach that follows a specific methodology, but the process ultimately relies upon auditor judgment.

## J. Program Risk

### 1. Criteria for Federal Program Risk

a. Current and prior audit experience could indicate higher risk:

(1) Multiple internal control structures.

(2) Weak monitoring systems for subrecipients.

(3) Programs not recently audited as major.

b. Oversight exercised by federal agencies and pass-through entities can be used to assess risk.

c. The inherent risk of a federal program is increased by:

(1) The complexity of the program (e.g., complex eligibility requirements).

(2) Being in the early phase of a program's life cycle (with new or untested requirements).

### 2. Criteria for a Low-Risk Auditee

a. Single audits have been performed on an annual basis for two years.

b. The financial statements received an unmodified opinion.

c. No deficiencies in internal control were identified.

d. No going concern contingencies were reported.

e. Type A programs, that had:

(1) No findings

(2) No questioned costs in excess of 5 percent of the award expended

(3) No modified opinion

## VIII. REPORTING REQUIREMENTS

### A. Summary of Recommended Reporting

The following chart summarizes when each of four reports is required.

| RECOMMENDED REPORTING | | | |
|---|---|---|---|
| | REQUIRED BY | | |
| *Report* | *GAAS* | *Government Auditing Standards* | *Single Audits* |
| Opinion (or disclaimer) on financial statements and supplementary schedule of expenditures of federal awards | ✓ | ✓ | ✓ |
| Report on internal control and compliance with provisions of laws, regulations, contracts, and grant agreements | | ✓ | ✓ |
| Report on compliance and internal control over compliance applicable to each major program. This report must include an opinion (or disclaimer) on compliance | | | ✓ |
| Schedule of findings and questioned costs | | | ✓ |

**PASS KEY**

Remember that government audits require more work and responsibility for the auditor. The examiners usually focus on the additional audit report requirements.

**PASS KEY**

Government audit reports focus the reader on compliance with laws, rules, and regulations, the internal controls associated with maintaining compliance, and any findings of noncompliance.

# QUALITY CONTROL STANDARDS

## I. APPLICABILITY

The AICPA Code of Professional Conduct requires firms providing auditing, attestation, and accounting and review services to adopt a system of quality control. A quality control system consists of policies and procedures designed, implemented, and maintained to ensure that the firm complies with professional standards and appropriate legal and regulatory requirements, and that any reports issued are appropriate in the circumstances. Statements on Quality Control Standards (SQCS) are issued by the Auditing Standards Board to provide guidance with respect to quality control.

## II. ELEMENTS

The six interrelated elements of quality control are:

H **H**uman resources

E **E**ngagement/client acceptance and continuance

L **L**eadership responsibilities

P **P**erformance of the engagement

M **M**onitoring

E **E**thical requirements

| PASS KEY |
|---|
| "HELP ME" maintain good quality in my accounting and auditing practice. |

### H A. Human Resources

1. This element encompasses criteria for recruitment and hiring, determining capabilities and competencies, assigning personnel to engagements, professional development, and performance evaluation, compensation, and advancement.

2. Personnel management policies and procedures should be established to provide the firm with reasonable assurance that:

   a. Those hired possess the appropriate characteristics to enable them to perform competently.

   b. Engagement partners possess the competencies necessary to fulfill engagement responsibilities.

   c. Work is assigned to personnel having the degree of technical training and proficiency required in the circumstances.

   d. Personnel participate in continuing professional education and other professional development activities.

   e. Personnel selected for advancement have the qualifications necessary to fulfill the responsibilities to be assumed, and performance evaluation, compensation, and advancement procedures provide appropriate recognition and reward.

3. Examples include:

   a. Requiring timely identification of staffing requirements.

   b. Planning for the total personnel needs of all the firm's professional engagements.

   c. Requiring a background check on new personnel.

   d. Requiring supervisors to prepare performance evaluations.

   e. Requiring personnel to attend training.

   f. Consideration of continuity and periodic rotation of personnel.

   g. Consideration of opportunities for on-the-job training.

E **B. Engagement/Client Acceptance and Continuance**

1. Policies and procedures should be established for deciding whether to accept or continue a client relationship and whether to perform a specific engagement. These policies and procedures should provide the firm with reasonable assurance that the firm:

   a. Minimizes the likelihood of association with a client whose management lacks integrity.

      (1) The firm should consider the reputation of the client, its owners, key management, related parties and those charged with governance, the nature of the client's operations, and the client's overall attitude towards matters such as the aggressive application of accounting principles and internal controls.

   b. Undertakes only those engagements that the firm can reasonably expect to complete with professional competence.

      (1) The firm must have sufficient personnel with appropriate knowledge and experience, or personnel who can attain appropriate competency levels. Specialists should be available if needed.

      (2) The firm must be able to perform the engagement within reporting deadlines.

   c. Can comply with legal and ethical requirements.

      (1) Potential conflicts of interest should be identified and evaluated.

      (2) The firm must be able to maintain independence.

2. The firm should document how any issues with respect to the acceptance and continuance decision were resolved.

3. The firm should obtain an understanding with the client regarding the nature, scope, and limitations of the services to be provided.

4. The firm should have policies and procedures for withdrawal from an engagement or from an engagement and the client relationship. Policies and procedures should include:

   a. Documentation of significant issues, consultations, conclusions, and the basis for conclusions.

b. Discussion with the client of the appropriate action to be taken by the firm based on the facts and circumstances. The discussion should include the appropriate level of the client's management and those charged with governance.

c. Consideration of any professional, legal or regulatory requirement for the firm to remain in place, or for the firm to report the withdrawal and the reasons for the withdrawal to regulatory authorities.

5. Examples include:

   a. Reviewing the financial statements and credit rating of the proposed client.

   b. Inquiring of third parties as to the reputation of the proposed client.

   c. Evaluating the firm's ability to service the client properly.

   d. Periodically reevaluating clients for continuance, including consideration of significant issues that arose during the current or prior engagements.

L **C. Leadership Responsibilities for Quality Within the Firm**

The firm's leadership bears ultimate responsibility for the firm's quality control system, and should create a culture that emphasizes quality. The "tone at the top" influences attitudes throughout the firm. Control env.

R
I
M
E

1. Quality should be emphasized over commercial considerations.

2. Performance evaluation, compensation, and advancement should demonstrate a commitment to quality.

3. Sufficient resources should be devoted to developing, communicating, and supporting the quality control system.

4. Those with operational responsibility for the quality control system should have appropriate experience, ability, and authority.

P **D. Performance**

Policies and procedures should be established to:

1. Achieve a consistently high level of performance. This may be accomplished by using written or electronic manuals, software tools, standardized documentation, and/or guidance materials for specific industries or specific types of subject matter.

2. Ensure that the engagement is appropriately supervised, and that work is appropriately reviewed.

3. Maintain confidentiality, safe custody, integrity, accessibility, retrievability, and retention of engagement documentation. Requirements imposed by specific laws or regulations should be addressed.

4. Allow consultation with experts inside or outside the firm with respect to complex, unfamiliar, unusual, difficult, or contentious issues.

5. Provide a means to resolve differences of opinion.

6. Establish and follow guidelines with respect to determining when an engagement quality control review should be performed.

   a. Care should be taken to appoint an appropriate (i.e., independent, technically competent) quality control reviewer.

b. The engagement partner remains responsible for the engagement, despite the involvement of an engagement quality control reviewer.

c. Engagement quality control review procedures should include an objective evaluation of judgments, conclusions, reports, and documentation.

d. The engagement quality control review should be appropriately documented.

e. The review should be completed before the engagement report is released.

7. Examples include:

a. Designating individuals with expertise in matters related to the SEC.

b. Referring questions to the appropriate group in the AICPA or state society.

c. Developing and using standard audit forms, checklists, and questionnaires.

d. Establishing procedures for reviewing engagement documentation and reports.

e. Using passwords or other means of restricting access to engagement documentation.

## M E. Monitoring

1. Policies and procedures should be established to provide the firm with reasonable assurance that its quality control system is relevant, adequate, operating effectively, and complied with in practice.

a. Monitoring involves an ongoing consideration and evaluation of the design and effectiveness of the quality control system.

b. Monitoring helps the company determine whether:

(1) The firm has complied with professional standards and legal/regulatory requirements.

(2) The quality control system has been designed appropriately and implemented effectively.

(3) The quality control system has operated effectively in ensuring that reports issued are appropriate.

c. Monitoring should be performed by qualified individuals.

d. A partner (or someone with appropriate experience and authority) should bear responsibility for the monitoring process.

2. Monitoring procedures include the performance of engagement quality control reviews, post-issuance reviews of engagement documentation, and inspections (internal or external) of a selection of completed engagements. Specific monitoring procedures include:

a. Review of administrative records, working papers, reports, and financial statements.

b. Discussions with firm personnel, including communication with management.

c. Summarization of findings, and determination of corrective actions to take.

d. Assessment of the firm's guidance materials, and compliance with firm guidelines.

e. Peer review conducted under AICPA standards, which may substitute for some of a firm's inspection procedures. (See item 5, below.)

f. A "wrap-up" or second partner "preissuance" review of the audit documentation by a partner not otherwise involved in the audit. The Sarbanes-Oxley Act requires such review for every public company audit report. The purpose of this review is to focus on the fair presentation of the financial statements in conformity with generally accepted accounting principles.

3. The firm should take appropriate further action to address deficiencies, complaints, and allegations of noncompliance.

4. Monitoring procedures should be documented, including evaluation of deficiencies noted and corrective actions taken.

**5. Peer Review**

**a. Self-Regulation**

Peer review every 3 years

Peer review occurs when one CPA firm reviews another CPA firm's compliance with its quality control system. A CPA firm that is a member of the AICPA must have a peer review every three years in order to maintain membership in the AICPA. The firm being reviewed can select the review firm or may ask the AICPA or state society of CPAs to select a review team.

**b. Purpose**

The purpose of peer review is to determine and report whether the CPA firm being reviewed has developed adequate policies and procedures for the elements of quality control and is following them in practice.

**c. Results**

Upon completion of the peer review, a report is issued with conclusions and recommendations. A firm that fails to take corrective actions (where necessary to correct deficiencies) is subject to sanctions.

E **F. Ethical Requirements** To maintain public confidence in the profession

1. Policies and procedures should be established to provide the firm with reasonable assurance that personnel maintain independence (in fact and in appearance) in all required circumstances, perform all professional responsibilities with integrity, and maintain objectivity in discharging professional responsibilities.

a. Independence encompasses impartiality and freedom from any obligation to or interest in the client.

b. Independence requirements should be communicated to firm personnel.

c. Threats to independence should be identified and evaluated, and appropriate action should be taken.

d. At least annually, all firm personnel subject to independence requirements should confirm their independence in writing (paper or electronic form).

e. The firm's quality control system should address requirements for rotation of personnel.

2. Examples include:

   a. Maintaining records showing which personnel were previously employed by clients or have relatives holding key positions with clients.

   b. Notifying personnel as to the names of audit clients publicly held.

   c. Confirming with staff that prohibited relationships do not exist.

   d. Emphasizing independence of mental attitude in training and supervision.

SOX

- Prohibits other services for audits of "issuers" (public company)
- Tax services for corp. audit client are OK (put in writing)

One year cool-off (partner→officer)

3. The Sarbanes-Oxley Act (applying to audits of issuers) contains certain provisions that must be followed to maintain auditor independence.

   a. Audit firms may not perform the following non-audit services contemporaneously with the audit: bookkeeping, financial information systems design/implementation, appraisal/valuation services, actuarial services, internal audit outsourcing services, management/human resource functions, investment services, legal services, and expert services unrelated to the audit.

      (1) Other non-audit services (e.g., tax services) may be performed if they are preapproved by the audit committee and disclosed to investors in periodic reports.

      (2) Proposed tax services and related fees must be communicated to the audit committee in writing. The potential effects of the services on the firm's independence should also be discussed with the audit committee, and this discussion must be documented.

OK

   b. Audit firms may not audit public companies whose CEO, CFO, etc., is also a previous employee of the accounting firm who worked on the audit during the preceding year.

   c. The lead partner and the reviewing partner must rotate off the audit every five years. Per SEC rules, the lead partner and the reviewing partner are subject to a five-year time out period before returning to the engagement. All other audit partners must rotate off the audit every seven years and are subject to a two-year time out period.

   d. Audit firms may not enter into contingent fee arrangements (i.e., those in which the amount of the fee is dependent upon the results of the services performed) with audit clients.

   e. Audit firms may not provide to audit clients any tax services related to certain confidential or aggressive tax transactions.

   f. Audit firms may not provide any tax services to corporate officers of audit clients, or to family members of corporate officers.

Not OK

**PASS KEY**

Routine tax return preparation, tax planning, and employee personal tax services are not prohibited by the Sarbanes-Oxley Act.

For the corporation

## III. OTHER CONSIDERATIONS

### A. Nature and Extent of Quality Control

The nature and extent of a firm's quality control policies and procedures depend on:

1. the firm's size;
2. its organizational structure;
3. the nature and complexity of its practice;
4. the degree of operating autonomy allowed its personnel and its individual offices; and
5. cost-benefit considerations.

### B. Communication

Quality control policies and procedures should be communicated to firm personnel.

1. Written communication is not required, but it can be helpful.
2. Communication should include procedures and objectives, and should emphasize personal responsibility and the importance of feedback.

### C. Documentation

The firm should document its quality control policies and procedures.

1. The extent of documentation may vary based on the size, structure, and nature of the firm.
2. Documentation should be retained for a sufficient period of time.

### D. Relationship Between Auditing Standards and Quality Control Standards

**1. GAAS vs. Quality Control Standards**

a. Generally accepted auditing standards and quality control standards are not synonymous. GAAS relate to the conduct of each individual audit engagement, whereas quality control standards relate to the conduct of all professional activities of the firm's practice as a whole.

b. The quality control standards of a firm affect both the performance of each audit and the performance of the audit practice as a whole.

**2. Quality Control Deficiencies**

a. While an effective system of quality control is conducive to complying with GAAS (or other professional standards), deficiencies in or noncompliance with a firm's quality control standards do not necessarily indicate a lack of compliance with GAAS (or other professional standards) for any one specific engagement.

b. Deficiencies in quality control for an individual engagement do not necessarily imply that the firm's quality control system overall is insufficient.

Failed quality control ≠ Failed GAAS

## IV. QUALITY CONTROL STANDARDS FOR AN ENGAGEMENT

The auditor has specific responsibilities regarding quality control procedures when performing engagements in accordance with U.S. GAAS. Such engagements include financial statement audits, reviews of interim financial statements, and government financial audits performed in accordance with GAAS. As part of a firm's system of quality control, engagement teams have a responsibility to implement quality control procedures that are applicable to the engagement. Engagement teams should also provide the firm with information related to the independence of the engagement team.

### A. Objective

The objective of the auditor is to implement quality control procedures at the engagement level to provide reasonable assurance that:

1. The audit complies with professional standards and applicable legal and regulatory requirements.
2. The auditor issues a report that is appropriate.

### B. Engagement Partner Responsibilities for Quality

The engagement partner is responsible for the overall quality of the engagement, but may delegate responsibility for the performance of certain procedures to other members of the engagement team. The engagement partner may also rely on the firm's system of quality control.

During each engagement, the engagement partner should:

1. Remain alert for evidence of noncompliance with relevant ethical requirements by members of the engagement team and take appropriate action when necessary.
2. Form a conclusion on compliance with independence requirements.
3. Be satisfied that appropriate procedures regarding client acceptance and continuance have been followed.
4. Be satisfied that the engagement team and any external specialists have the competence and capabilities needed to perform the engagement and issue an audit report that is appropriate in the circumstances.
5. Take responsibility for the direction, supervision, and performance of the engagement and for the report being appropriate in the circumstances.
6. Take responsibility for reviews being performed in accordance with the firm's review policies and procedures.
7. Be satisfied through review of the audit documentation and discussion with the engagement team that sufficient appropriate audit evidence has been obtained to support the conclusions reached and the report to be issued.
8. Take responsibility for the engagement team undertaking appropriate consultation on difficult or contentious matters.

### C. Engagement Quality Control Review

The engagement quality control review provides an objective evaluation of the significant judgments the engagement team made and the conclusions it reached in formulating the auditor's report. An engagement quality control review is performed only when required by the firm's policies and procedures.

**1. Engagement Quality Control Reviewer**

The engagement quality control reviewer can be a partner, other person in the firm, suitably qualified external person, or team of such individuals, none of whom is part of the engagement team. The engagement quality control reviewer must have sufficient and appropriate experience and authority to objectively evaluate the engagement team's judgments and conclusions.

**2. Timing**

The engagement quality control review should be completed before the engagement partner releases the audit report.

**3. Procedures**

The engagement quality reviewer's evaluation of the engagement team's significant judgments and conclusions should include:

a. Discussion of significant findings with the engagement partner.

b. Reading the financial statements and proposed auditor's report.

c. Review of audit documentation related to significant judgments and conclusions.

d. Evaluation of the conclusions reached in formulating the auditor's report and consideration of the appropriateness of the proposed auditor's report.

**4. Effect on Auditor's Report Date**

If the engagement quality control review is completed after the date of the auditor's report and identifies instances where additional evidence or procedures are required, the date of the auditor's report should be changed to the date when the additional evidence has been obtained or the additional procedures have been completed.

**U.S. AUDITING STANDARDS VS. INTERNATIONAL STANDARDS ON AUDITING**

ISA 220 requires that the engagement quality review be completed before the engagement partner dates the auditor's report. Under U.S. auditing standards, the engagement quality review is an independent review of all significant judgments made by the engagement team, including the date selected by the engagement team as the audit report date. When an engagement quality control review under U.S. auditing standard results in additional procedures being performed, the date of the auditor's report should be changed.